

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 241

[Release No. 34-54165; File No. S7-13-06]

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

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Interpretation; solicitation of comment.

**SUMMARY:** The Securities and Exchange Commission is publishing this interpretive release with respect to the scope of “brokerage and research services” and client commission arrangements under Section 28(e) of the Securities Exchange Act of 1934 (“Exchange Act”). The Commission is soliciting further comment on client commission arrangements under Section 28(e).

**DATES:** *Effective Date:* July 24, 2006.

*Comment Due Date:* Comments should be received on or before September 7, 2006.

*Other Date:* Market participants may continue to rely on the Commission’s prior interpretations of Section 28(e) until January 24, 2007.

**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 S7-13-06 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 Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-13-06. 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)<sup>1</sup> of the Exchange Act<sup>2</sup> 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 issuing 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.

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>3</sup> Use of client commissions to 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>4</sup> Recognizing the value of research in managing client accounts, however, Congress enacted Section 28(e)<sup>5</sup> of the Exchange Act 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>6</sup>

As discussed below in Section 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 broker-dealers and investment advisers.<sup>7</sup> The Commission also has

<sup>4</sup> For a discussion of managers’ conflicts in connection with the safe harbor, see generally 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). Similarly, to minimize confusion with the phrase “commission-sharing arrangements” as used in the United Kingdom to refer to unique arrangements in that market place, we refer to arrangements under Section 28(e) as “client commission arrangements” or “Section 28(e) arrangements.”

<sup>5</sup> 15 U.S.C. 78bb(e).

<sup>6</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.

<sup>7</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>1</sup> 15 U.S.C. 78bb(e).

<sup>2</sup> 15 U.S.C. 78a.

<sup>3</sup> Money managers include investment advisers, who have 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 their clients, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 189-191 (1963). This includes the obligation to seek “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 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 § 170 cmt. a, § 216 (1959).

brought enforcement actions involving purported client commission practices.<sup>8</sup>

On October 19, 2005, the Commission issued a proposed interpretive release regarding client commission practices under Section 28(e) ("Proposing Release").<sup>9</sup> We received letters from seventy-one commenters in response to the Proposing Release.<sup>10</sup> More than half

<sup>8</sup> See, e.g., *Dawson-Samberg Capital Management, Inc. and Judith A. Mack*, Advisers Act Release No. 1889, 54 SEC 786 (Aug. 3, 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.*, Litigation Release No. 15664, 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.*, Litigation Release No. 14315, 57 SEC Docket 2593 (Nov. 1, 1994).

<sup>9</sup> Exchange Act Release No. 52635 (Oct. 19, 2005), 70 FR 61700 (Oct. 25, 2005).

<sup>10</sup> Seventy-one different commenters submitted seventy-six comment letters. The comment letters are available for inspection in the Commission's Public Reference Room in File No. S7-09-05, or may be viewed at <http://www.sec.gov/rules/interp/s70905.shtml>. The commenters were: Committee on Federal Regulation of Securities, Business Law Section, American Bar Association ("ABA"); Adams Harkness ("Adams Harkness"); American Bankers Association ("AmBankers"); The Alliance in Support of Independent Research, Nov. 23, 2005 ("ASIR 1"); The Alliance in Support of Independent Research, June 2, 2006 ("ASIR 2"); Axia Advisory Corporation ("Axia"); Bingham McCutcheon LLP, on behalf of Frank Russell Securities, Inc. ("Bingham McCutcheon"); Bloomberg L.P. ("Bloomberg"); BNY Securities Group on behalf of the Bank of New York Company, Inc., Nov. 25, 2005 ("BNY 1"); BNY Securities Group on behalf of the Bank of New York Company, Inc., May 2, 2006 ("BNY 2"); California Public Employees' Retirement System ("CalPERS"); Capital Institutional Services, Inc. ("CAPIS"); Carolina Capital Markets, Inc., Nov. 23, 2005 ("CCM 1"); Carolina Capital Markets, Inc., Nov. 25, 2005 ("CCM 2"); CFA Centre for Financial Market Integrity, CFA Institute ("CFA Institute"); Consumer Federation of America/Fund Democracy (joint letter) ("CFA/FD"); Charles River Brokerage ("Charles River"); C.L. King & Associates, Inc. ("CL King"); Commission Direct, Inc. ("Commission Direct"); Credit Suisse Securities (USA) LLC ("Credit Suisse"); Neal J. Dean ("Dean"); U.S. Department of Labor, Employee Benefits Security Administration ("DOL"); Michael Donovan ("Donovan"); Dow Jones & Company, Inc. ("Dow Jones"); E\*Trade Financial Corporation ("E\*Trade"); European Association of Independent Research Providers ("EuroIRP"); Eze Castle Software ("Eze Castle"); Fidelity Management and Research Company ("Fidelity"); FinTech Securities ("FinTech"); Tamar Frankel ("Frankel"); William T. George, Oct. 20, 2005 ("George 1"); William T. George, Oct. 28, 2005 ("George 2"); William T. George, Apr. 4, 2006 ("George 3"); GovernanceMetrics International ("GMI"); Independent Directors Council ("IDC"); Instinet, LLC ("Instinet"); International Securities Association for Institutional Trade Communications ("ISITC"); The Interstate Group ("Interstate

of the commenters supported the Commission's efforts in the Proposing Release to clarify the scope of Section 28(e).<sup>11</sup> Overall, the comments provided useful information regarding industry practices in this area.<sup>12</sup>

After considering the comments received and the Commission's experience with Section 28(e), and upon further examination of changing market conditions, current industry practices, and the purposes underlying Section 28(e), we are issuing this interpretive release on money managers' use of client assets to pay for research and brokerage services under Section 28(e) of the Exchange Act.<sup>13</sup> This release interprets the scope of the safe harbor as follows:

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

Group"); Investment Adviser Association ("IAA"); Investment Company Institute ("ICI"); Investment Management Association ("IMA"); Investors' Research Association ("Investorside"); International Shareholder Services Inc. ("ISS"); ITG Inc. ("ITG"); J.P. Morgan Securities Inc., Nov. 28, 2005 ("JP Morgan 1"); J.P. Morgan Securities Inc., Mar. 28, 2006 ("JP Morgan 2"); Thomas F. Lamprecht ("Lamprecht"); Mellon Financial Corporation ("Mellon"); Merrill Lynch & Co., Inc. ("Merrill"); Managed Funds Association ("MFA"); Mutual Fund Directors Forum ("MFDF"); Morgan Stanley & Co., Inc. ("Morgan Stanley"); Missouri State Employees' Retirement System ("MOSERS"); Emmett Murphy ("Murphy"); National Compliance Services, Inc. ("NCS"); Bernard Notas ("Notas"); National Society of Compliance Professionals Inc. ("NSCP"); Junius W. Peake, Oct. 21, 2005 ("Peake 1"); Junius W. Peake, Oct. 26, 2005 ("Peake 2"); Rainier Investment Management, Inc. ("Rainier"); The Reserve Funds ("Reserve"); Reuters America LLC ("Reuters"); Riedel Research Group ("Riedel"); Charlotte Roederer ("Roederer"); Sanderson & Stocker, Inc. ("Sanderson & Stocker"); U.S. Senator Charles C. Schumer and U.S. Senator John E. Sununu (joint letter) ("Senators Schumer and Sununu"); Charles Schwab & Co., Inc. ("Schwab"); Seward & Kissel LLP ("Seward & Kissel"); Securities Industry Association ("SIA"); Security Traders Association ("STA"); T. Rowe Price Associates, Inc. ("T. Rowe Price"); UBS Securities LLC ("UBS"); Vandham Securities Corp. ("Vandham"); The Vanguard Group, Inc. ("Vanguard"); Ward & Smith, P.A. on behalf of First Citizens Bank & Trust Company ("Ward & Smith"); West Virginia Investment Management Board ("WVIMB").

<sup>11</sup> ABA; ASIR 1; AmBankers; BNY; Bloomberg; CalPERS; CAPIS; CFA Institute; Charles River; Commission Direct; DOL; Dow Jones; E\*Trade; EuroIRP; Eze Castle; Fidelity; FinTech; IDC; ISS; Interstate Group; IAA; ICI; IMA; Investorside; ITG; JP Morgan 1; MFA; Mellon; Merrill; Morgan Stanley; NCS; NSCP; Reuters; Riedel; Roederer; Schwab; SIA; STA; T. Rowe Price; UBS; Vandham; Vanguard.

<sup>12</sup> Ten commenters expressed the view that money managers should refrain from using client commissions to obtain brokerage and research or that Congress should repeal Section 28(e). See Axia; CFA/FD (joint letter); Dean; Frankel; MOSERS; MFDF; Peake 2; Reserve; WVIMB.

<sup>13</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.

• 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.

• Research related to the market for securities, such as trade analytics (including analytics available through order management systems) and advice on market color and execution strategies, are eligible for the safe harbor.

• Market, financial, economic, and similar data could be eligible for the safe harbor.

• Mass-marketed publications are not eligible as research under 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.

• Eligibility of both brokerage and research services for safe harbor protection is governed by the criteria in Section 28(e)(3),<sup>14</sup> consistent with the Commission's 1986 "lawful and appropriate assistance" standard.

• Mixed-use items must be reasonably allocated between eligible and ineligible uses, and the manager must keep adequate books and records concerning allocations so as to enable the manager to make the required good faith determination of the reasonableness of commissions in relation to the value of brokerage and research services.

• In order for the safe harbor to be available to the money manager, the following principles apply:

• Broker-dealers that are parties to arrangements under Section 28(e) are involved in "effecting" the trade if they execute, clear, or settle the trade, or perform one of four specified functions<sup>15</sup> and allocate the other functions to another broker-dealer.

• Broker-dealers "provide" the research if they (i) prepare the research, (ii) are financially obligated to pay for the research, or (iii) are not financially obligated to pay but their arrangements have certain attributes.

<sup>14</sup> 15 U.S.C. 78bb(e)(3).

<sup>15</sup> The four functions are: (1) Taking financial responsibility for customer trades; (2) maintaining records relating to customer trades; (3) monitoring and responding to customer comments concerning the trading process; and (4) monitoring trades and settlements. See discussion *infra* note 176 and accompanying text.

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.

The guidance in this Release shall be effective immediately upon its publication in the **Federal Register**. Market participants may continue to rely on the Commission's prior interpretations for six months following the publication of this Release in the **Federal Register**. Nonetheless, the Commission will receive and consider additional comment regarding Section III.I of this Release with respect to client commission arrangements given evolving developments in the industry. Based on any comments received, the Commission may, but need not, supplement the guidance in this Release in the future.

## 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 1970's, 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>16</sup> At the same time, the House and Senate began to consider whether to eliminate fixed commission rates legislatively.<sup>17</sup> The Commission adopted Rule 19b-3 under the Exchange Act,<sup>18</sup> which ended fixed commission rates on national securities exchanges effective May 1, 1975.<sup>19</sup> Just one month later, Congress passed legislation unfixing commission rates as part of the

Securities Acts Amendments of 1975 ("1975 Amendments").<sup>20</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>21</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>22</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>23</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>24</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>25</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 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>26</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 this conflict 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>27</sup>

<sup>25</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>26</sup> See *supra* note 3.

<sup>27</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, transactions for which the client has directed the money manager to a particular broker in order to recapture a portion of the commission for that client or to pay expenses of that client such as sub-transfer agent fees, consultants' fees, or administrative services fees generally do not raise the types of conflicts for the money manager that the safe harbor of Section 28(e) was designed to address. See, e.g., 1986 Release, 51 FR at 16011. These types of directed brokerage arrangements typically involve use of a client's commission dollars to obtain services that directly and exclusively benefit the client. See Payment for Investment Company Services with Brokerage

<sup>16</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>17</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>18</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>19</sup> See Exchange Act Release No. 11203 (Jan. 23, 1975), 40 FR 7394 (Feb. 20, 1975).

<sup>20</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>21</sup> See Exchange Act Release No. 12251 (Mar. 24, 1976), 41 FR 13678, 13679 (Mar. 31, 1976) ("1976 Release").

<sup>22</sup> See Special Study, H.R. Doc. No. 88-95, pt. 2, at 321.

<sup>23</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>24</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.).

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 Advisers Act<sup>28</sup> and the Investment Company Act of 1940 (“Investment Company Act”),<sup>29</sup> and the Employee Retirement Income Security Act of 1974 (“ERISA”).<sup>30</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 and ERISA, respectively, unless they satisfy the requirements of the Section 28(e) safe harbor.<sup>31</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>32</sup> We discuss these below.

Commissions, Securities Act Release No. 7197 (July 21, 1995), 60 FR 38918 (July 28, 1995).

<sup>28</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 that impose disclosure and other obligations on investment advisers and related persons).

<sup>29</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>30</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>31</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 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, for or to 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>32</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,

### 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>33</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>34</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>35</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>36</sup> The Commission emphasized that the money manager

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.*, Litigation Release No. 15664, 66 SEC Docket 1613 (Mar. 10, 1998), 1999 U.S. Dist. LEXIS 22298 (1999) (order granting permanent injunction and other relief); *Renaissance Capital Advisors, 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.*, Litigation Release No. 14315, 57 SEC Docket 2593 (Nov. 1, 1994).

<sup>33</sup> 1976 Release, 41 FR at 13678.

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

<sup>35</sup> *Id.* at 13679.

<sup>36</sup> *Id.*

“should be prepared to demonstrate the required good faith determination in connection with the transaction.”<sup>37</sup>

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

In 1980, the Commission issued a report pursuant to Section 21(a) of the Exchange Act following an investigation of Investment Information, Inc.'s (“III”) purported client commission arrangements (“III Report”).<sup>38</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>39</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>40</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

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

<sup>38</sup> See III Report, 19 SEC Docket at 926.

<sup>39</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>40</sup> *Id.* at 931-32.

“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>41</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>42</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>43</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>44</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>45</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>46</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>47</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>48</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>49</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>50</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>51</sup>

In 2001, the Nasdaq Stock Market asked the Commission to reconsider this interpretation of Section 28(e) to apply 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>52</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>53</sup>

### C. 1998 Office of Compliance Inspections and Examinations 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>54</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>55</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>56</sup>

<sup>51</sup> 2001 Release, 67 FR at 7.

<sup>52</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>53</sup> 2001 Release, 67 FR at 7.

<sup>54</sup> See 1998 OCIE Report, at 3.

<sup>55</sup> 1998 OCIE Report, at 4–5.

<sup>56</sup> *Id.* at 47–52.

<sup>46</sup> *Id.* at 16006.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* at 16007.

<sup>50</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>41</sup> *Id.* at 932.

<sup>42</sup> 1986 Release, 51 FR at 16005.

<sup>43</sup> *Id.* at 16005–06.

<sup>44</sup> *Id.* at 16006.

<sup>45</sup> *Id.* at 16007.

#### 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 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>57</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>58</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>59</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>60</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>61</sup>

<sup>57</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>58</sup> NASD Task Force Report, at 5.

<sup>59</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>60</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>61</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

#### 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>62</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>63</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>64</sup> The rules became effective beginning in January 2006, with a transitional period until June 2006.<sup>65</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 United Kingdom. To the extent that the Commission's approach to client commissions is compatible with that taken in the United Kingdom, market participants' costs of compliance with multiple regulatory regimes are reduced. Therefore, we have taken the FSA's work into account in developing our position in this release, while

transaction costs. NASD Task Force Report, at 4. See *supra* note 13.

<sup>62</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>63</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>64</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/pfcd2.pdf>.

<sup>65</sup> FSA Final Rules, at 5. Firms were permitted to continue to comply with existing rules until the earlier of the expiration of existing agreements or June 30, 2006.

recognizing the significant differences in our governing law and rules, such as the fact that the United Kingdom does not have a statutory provision similar to Section 28(e).<sup>66</sup> This interpretive guidance is generally consistent with the FSA's rules, with a few exceptions.<sup>67</sup>

### III. Commission's Interpretive Guidance

In light of developments in client commission practices, evolving technologies, marketplace developments, the observations of the staff in examinations of industry participants, and comments received on the Proposing Release, 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 providing a revised interpretation that replaces Sections II and III of the 1986 Release.<sup>68</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 are issuing guidance on third-party research and client commission arrangements and are seeking further comment relating to client commission arrangements (Section III.I of this Release).

Section 28(e) applies equally to arrangements involving client commissions paid to full service broker-

<sup>66</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/77D7FCEFB7653EC5CA256EAF0002F6C2?opendocument](http://www.asic.gov.au/asic/ASIC_PUB.NSF/byid/77D7FCEFB7653EC5CA256EAF0002F6C2?opendocument).

<sup>67</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 subscriptions for publications and seminar fees as "non-permitted" services. FSA Final Rules, at 2.15 and Annex, p. 9 (Conduct of Business Sourcebook Rules 7.18.7, 7.18.8(d), and 7.18.8(e)).

<sup>68</sup> Our interpretation does not replace other sections of the 1986 Release.

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>69</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>70</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 arrangement that, in the staff's view, was outside of the scope of Section 28(e) and the 1986 Release.<sup>71</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>72</sup> Examples of non-research items included: Chartered 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>73</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>74</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>75</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>76</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>77</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>78</sup> As a step to address the present environment and comments received in response to the Proposing Release, the Commission has determined to provide further guidance on the scope of the safe harbor.<sup>79</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>80</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 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

<sup>78</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 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>79</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>80</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).

<sup>69</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 *infra* note 82.

<sup>70</sup> 1998 OCIE Report, at 31.

<sup>71</sup> *Id.* at 22, 31.

<sup>72</sup> *Id.* at 31.

<sup>73</sup> *Id.* at 31-32.

<sup>74</sup> *Id.* at 34-35.

<sup>75</sup> *Id.* at 49.

<sup>76</sup> See *id.* at 3-4, 31-32.

<sup>77</sup> See *id.* at 4-6, 32-33.

“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.<sup>81</sup> In the 1986 Release, the Commission adopted the “lawful and appropriate assistance” standard for “brokerage and research services,”<sup>82</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.<sup>83</sup> First, the money manager must determine whether the product or service falls within the specific statutory limits of Section 28(e)(3) (*i.e.*, whether it is eligible “research” under Section 28(e)(3)(A) or (B) or eligible “brokerage” under Section 28(e)(3)(C)).<sup>84</sup> Second,

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. Where a product or service has a mixed use, a money manager must make a reasonable allocation of the costs of the product according to its use. 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>85</sup> We discuss these statutory elements in more detail below.

### C. Eligibility Criteria for “Research Services” Under Section 28(e)(3)

In response to the Proposing Release, nine comment letters supported the Commission’s proposed narrowing of the scope of research under Section 28(e).<sup>86</sup> Three commenters stated that the Commission’s approach did not sufficiently narrow the scope of “research,”<sup>87</sup> while another commenter recommended that the Commission improve clarity by providing extensive lists of research items that are eligible and ineligible for the Section 28(e) safe harbor.<sup>88</sup> Based on the language of the statute and our analysis of the legislative history, and taking into consideration the comments to the Proposing Release regarding the types of products and services paid for and their uses, we believe that the eligibility criteria for “research” under the safe harbor discussed in the Proposing Release and set forth below represents the appropriate interpretation of Section 28(e).

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>89</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>90</sup> 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, paper, or oral discussions) 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>91</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 are eligible under Section 28(e). Discussions with research analysts also fall squarely within the statute because they involve “furnish[ing] advice \* \* \* directly \* \* \* as to the \* \* \* advisability of investing in securities.” Thus, they reflect the expression of reasoning or knowledge (*i.e.*, furnishing advice) relating to the statutory subject matter (*i.e.*, the advisability of investing in securities). Meetings with corporate

<sup>89</sup> 15 U.S.C. 78bb(e)(3)(A)–(B) (emphasis added).

<sup>90</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, 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>91</sup> The content may be original research or a synthesis, analysis, or compilation of the research of others.

<sup>81</sup> Senate Comm. on Banking, Housing and Urban Affairs, Securities Acts Amendments of 1975, S. Rep. No. 94–75, at 74 (1975), *reprinted* in 1975 U.S.C.C.A.N. 179, 249.

<sup>82</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>83</sup> In the Commission’s view, the prudent way for a money manager to meet its burden of showing eligibility for the safe harbor is to document fully its client commission arrangements.

<sup>84</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; and (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-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>85</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>86</sup> ASIR 1; BNY 1; CFA Institute; FinTech; IMA; MFDF; NCS; T. Rowe Price; Vanguard.

<sup>87</sup> CFA/FD (joint letter); IDC.

<sup>88</sup> Notas.

executives to obtain oral reports on the performance of a company are eligible because reasoning or knowledge will be imparted at the meeting (*i.e.*, reports) about the subject matter of Section 28(e) (*i.e.*, concerning issuers). Seminars or conferences may also be eligible under the safe harbor if they truly relate to research, that is, they provide substantive content relating to the subject matter in the statute, such as issuers, industries, and securities.<sup>92</sup> Software that provides analyses of securities portfolios is eligible under the safe harbor because it reflects the expression of reasoning or knowledge relating to subject matter that is included in Section 28(e)(3)(A) and (B).<sup>93</sup> Corporate governance research (including corporate governance analytics) and corporate governance rating services could be eligible if they reflect the expression of reasoning or knowledge relating to the subject matter of the statute (for example, if they provide reports and analyses about issuers, which can have a bearing on the companies' performance outlook).<sup>94</sup>

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 is 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 are not eligible if the advice relates to the managers' internal management or operations.

### 1. Mass-Marketed Publications

The Proposing Release sought comment on whether the Commission should provide further guidance regarding mass-marketed publications.

<sup>92</sup> As discussed below, travel and related expenses (*e.g.*, meals and entertainment) associated with arranging trips to meet corporate executives or to attend seminars or conferences are not eligible under the safe harbor. 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>93</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>94</sup> This paragraph incorporates responses to commenters' requests to clarify the eligibility of the following: discussions with analysts (T. Rowe Price); meetings with corporate executives (Murphy; T. Rowe Price); and corporate governance research, corporate governance research analytics, and corporate governance rating services (GMI; ISS).

More than half of the commenters who discussed this issue indicated that mass-marketed publications were readily distinguishable from traditional research products and should be excluded from the safe harbor on that basis.<sup>95</sup> Other commenters believed that mass-marketed publications should be subjected to the same eligibility criteria as other forms of research.<sup>96</sup>

The congressional hearings on the 1975 Amendments and contemporaneous statements support the view that "research services" intended to be covered by the safe harbor are the types that broker-dealers had historically provided to money managers during the era of fixed commissions—exemplified by research reports produced by Wall Street brokerage firms—rather than newspapers, magazines, and other periodical publications that are in general circulation to the retail public.<sup>97</sup> Accordingly, we believe that Section

<sup>95</sup> Bloomberg; CFA/FD; George 2; ICI; IDC; Merrill Lynch; SIA; T. Rowe Price. Two other commenters seemed to believe that certain mass-marketed publications should be included and others excluded. Charles River; ISITC.

<sup>96</sup> ABA; CFA Institute; Commission Direct; Dow Jones; Reuters; Seward & Kissel. Commission Direct questioned whether, as a practical matter, managers will pay for mass-marketed publications under Section 28(e), noting that money managers that provide to clients a list of services paid for with commissions "will be very reluctant to identify ubiquitous newspapers or journals."

<sup>97</sup> S. 249 Hearings, at 201–205 (Statement of Ray Garrett, Jr., Chairman, U.S. Securities and Exchange Commission). See also S. 249 Hearings, at 330–31 (Combined statement of Baker, Weeks & Co., Inc., Donaldson, Lufkin & Jenrette Sec. Corp., Mitchell, Hutchins Inc., and Oppenheimer & Co.) (legislation is necessary to protect professional fiduciary's access to broker-generated research.); Harvey E. Bines, *The Law of Investment Management* 9–56 (1978); Richard L. Teberg and Mary B. Cane, *Paying Up for Research*, 115 *Trusts & Estates* 62 (January 1976) ("[T]he Wall Street Journal or Fortune \* \* \* [and other] services, of course, are clearly not within the congressional purposes of Section 28(e) since they do not relate to the research or execution function."); A.A. Sommer, Jr., *A Glance at the Past, a Probe of the Future*, Address at the Mid-Continental District of the Securities Industry Association (Mar. 18, 1976) ("There continues to be the problem of how the good research capacity of Wall Street can be compensated and preserved \* \* \*"); James F. Jorden, *Paying Up for Research: A Regulatory and Legislative Analysis*, 1975 *Duke L.J.* 1103, 1123–24 (1975) ("[A] prudent adviser \* \* \* cannot use brokerage to purchase \* \* \* a subscription to the Wall Street Journal."). Speaking just weeks before the safe harbor legislation was signed into law, Commissioner Sommer stated: "Already we are being asked questions about what can properly be deemed research for which business may be allocated or commissions paid \* \* \*. [F]rankly I don't think a conscientious, scrupulous professional needs us to tell him that a subscription to The Wall Street Journal or Fortune, or legal or accounting services, or office furniture, is not the "research" which he can lawfully buy with his beneficiary's dollars." A.A. Sommer, Jr., *Have We Learned Anything?* Address at the Investment Company Institute (May 14, 1975), in *Securities Week*, 14 (May 19, 1975).

28(e) should not protect the money manager's purchase of publications that are mass-marketed. Mass-marketed publications are those publications that are intended for and marketed to a broad, public audience. Indicia of these mass-marketed publications include, among other things, that they are circulated to a wide audience, intended for and marketed to the public, rather than intended to serve the specialized interests of a small readership, and have low cost. These mass-marketed publications are more appropriately considered as overhead expenses of money managers.<sup>98</sup>

Our conclusion that the safe harbor of Section 28(e) should not include mass-marketed publications does not affect the eligibility of certain other publications that qualify as "research" under the guidance above. Indicia of publications that are not mass-marketed and could be eligible research under the safe harbor include, among other things, that they are marketed to a narrow audience, directed to readers with specialized interests in particular industries, products, or issuers, and have high cost. For example, financial newsletters and other financial and economic publications that are not targeted to a wide, public audience may be eligible research under the safe harbor. Trade magazines and technical journals concerning specific industries (*e.g.*, nano-technology) or product lines (*e.g.*, medical devices) are eligible as research under Section 28(e) if they are marketed to, and intended to serve the interests of a narrow audience (*e.g.*, physicians), rather than the general public.

The method of distribution of a publication does not determine whether it is mass-marketed. Thus, whether a publication is distributed in paper or electronically does not determine the availability of the safe harbor. Moreover, it is the focus of the marketing and not the availability of the publication that is an important criterion for determining the applicability of the safe harbor. Even if a publication that is marketed to a narrow audience, such as investment professionals, can be accessed over the internet by the general population, this does not alter its eligibility as research

<sup>98</sup> The Commission recognizes that mass-marketed publications can play a role in keeping money managers informed about matters relevant to the performance of their responsibilities. It is the Commission's expectation that money managers may market their services and receive advisory fees based on a fundamental level of knowledge about the industry, which could include review of these mass-marketed publications. Nonetheless, money managers should obtain these mass-marketed publications with their own funds, rather than have clients pay for them through commissions.

under Section 28(e). The purpose of such publications is to reach a small audience and to serve the specialized interests of a narrow group. Accordingly, if these publications otherwise meet the eligibility criteria for research (that is, they contain the expression of reasoning or knowledge related to the statutory subject matter), money managers can use client commissions to pay for them under Section 28(e).

## 2. Inherently Tangible Products and Services

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 do not constitute eligible “research services.”<sup>99</sup> For example, expenses for travel, entertainment, and meals associated with attending seminars, and travel and related expenses associated with arranging trips to meet corporate executives, analysts, or other individuals who may provide eligible research orally are not eligible under the safe harbor. Similarly, office equipment, office furniture and business supplies, salaries (including research staff), rent, accounting fees and software, Web site design, e-mail software, Internet service, legal expenses, personnel management, marketing, utilities, membership dues (including initial and maintenance fees paid on behalf of the money manager or any of its employees to any organization or representative or lobbying group or firm), professional licensing fees, and software to assist with administrative functions such as managing back-office functions, operating systems, word processing, and equipment maintenance and repair services are examples of other overhead items that do not meet the statutory criteria for research set forth in this release and are not eligible under the safe harbor.<sup>100</sup>

<sup>99</sup> See 1986 Release, 51 FR at 16006–07.

<sup>100</sup> According to the 1998 OCIE Report, advisers used client commissions to pay for many of these items. See notes 70–74 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).

Computer hardware, including computer terminals,<sup>101</sup> and computer accessories, while they may assist in the delivery of research, are not eligible “research services” because they do not reflect substantive content related in any way to making decisions about investing.<sup>102</sup> Similarly, the peripherals and delivery mechanisms associated with computer hardware or associated with the oral delivery of research, including telecommunications lines, transatlantic cables, and computer cables, are outside the “research services” safe harbor.<sup>103</sup>

## 3. Market Research

Based on the comments we received in response to the Proposing Release, we believe that technology now permits managers to obtain research related to the market for securities from many sources and products, and through many delivery mechanisms, including order management systems (“OMS”) and trade analytical software.<sup>104</sup> In many instances, this “market research” is the type of research report and advice

<sup>101</sup> The Proposing Release asked how investors, money managers, broker-dealers, and others would be affected by the Commission’s interpretive guidance that client commissions cannot be used to obtain computer equipment as research under Section 28(e). See Proposing Release, Question 2. Commenters either expressly supported the proposal to exclude computer equipment from the safe harbor (Bloomberg; Commission Direct; E\*Trade; IMA; Merrill; Reuters) or indicated that this position would have minimal impact to industry participants (Charles River; George 2). Four commenters sought clarification about whether computer terminals dedicated to the transmission of particular research products are eligible. IMA; Mellon; NCS; STA. For the reasons explained in this Release, we do not believe that any computer terminals are eligible “research” under Section 28(e).

<sup>102</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.

<sup>103</sup> As indicated above, the products or services delivered over computer terminals and T–1 lines may be eligible if they satisfy the criteria set forth in this Release.

<sup>104</sup> Twenty-one commenters to the Proposing Release indicated that OMS should be eligible under the safe harbor as brokerage or research. AmBankers; ASIR 1; BNY; CAPIS; Charles River; Eze Castle; IAA; ICI; IMA; Interstate; ISITC; ITG; Mellon; Merrill; Morgan Stanley; NSCP; Rainier; SIA; STA; UBS; Ward & Smith. Of these, fourteen commenters proposed that OMS should be eligible either as research services (if the Commission determined that they could not be appropriately analyzed as eligible brokerage) (CAPIS; Eze Castle; IAA; ICI; Interstate; ISITC; ITG; NSCP; Rainier) or as undifferentiated “brokerage and research services” (ASIR 1; BNY 1; Mellon; SIA; Ward & Smith).

historically provided directly by broker-dealers, such as advice on market color and execution strategies. Therefore, we believe that it is appropriate to clarify that “advice,” “analyses,” and “reports” regarding the market for securities—or “market research”—may be eligible under the safe harbor if they otherwise satisfy the standards for “research.” For example, market research that may be eligible under Section 28(e) can include pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research, including research on optimal execution venues and trading strategies.<sup>105</sup> In addition, advice from broker-dealers on order execution, including advice on execution strategies, market color, and the availability of buyers and sellers (and software that provides these types of market research) may be eligible “research” under the safe harbor.

## 4. Data

The Proposing Release proposed that data services, including market data, would be eligible under the safe harbor if the data reflected substantive content related to the subject matter categories identified in Section 28(e). Based on the comments received on this issue regarding the content and use of these products, we believe that the analysis regarding data set forth in the Proposing Release is appropriate.<sup>106</sup> In our view, this approach will promote innovation by money managers who use raw data to create their own research analytics, thereby leveling the playing field with those money managers who buy finished research, which incorporates raw data, from others. Additionally, we believe that excluding market data from the safe harbor could become meaningless if it encouraged purveyors of this information to simply add some minimal or inconsequential

<sup>105</sup> If these products and services also contain functionality that is not eligible brokerage or research under the safe harbor, or if the products and services are eligible brokerage or research but the money manager does not use them in a way that provides lawful and appropriate assistance in investment decision-making, they may be mixed-use items. See *infra* note 125.

<sup>106</sup> Eight commenters expressed views about market data. ASIR 1; CFA/FD; CFA Institute; IDC; IMA; Reuters; T. Rowe Price. Of these, four commenters advocated that data should be excluded from the safe harbor as overhead. CFA/FD; IDC; T. Rowe Price. An equal number supported the proposal to include market data in the safe harbor as research or as brokerage. ASIR 1; CFA Institute; IMA; Reuters. A ninth commenter, the SIA, implicitly endorsed the inclusion of market data in the safe harbor by describing market data as part of order management systems that should be eligible under Section 28(e).

functionality to the data to bring it within the safe harbor.

Accordingly, 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 the safe harbor as eligible “reports” provided that they satisfy the subject matter criteria and provide lawful and appropriate assistance in the investment decision-making process. 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>107</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), we 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>108</sup> and thus are eligible as “research services” under the safe harbor.<sup>109</sup> Other data are 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) are eligible as research under Section 28(e).

##### 5. Proxy Services

The Proposing Release requested information regarding industry practice with respect to proxy services (which include research and voting products and services provided by “proxy service” providers). The commenters that responded to this issue expressed the view that proxy services should qualify under the safe harbor depending on how they are used, and should be subject to the mixed-use criteria.<sup>110</sup> These commenters believe that certain proxy services should qualify as eligible

<sup>107</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>108</sup> 15 U.S.C. 78bb(e)(3)(B).

<sup>109</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>110</sup> ASIR 1; BNY 1; IAA; ICI; ISS; Mellon; Seward & Kissel.

research because they provide information and analysis that money managers consider when they determine the advisability of investing in, or retaining a position in, a security. Some of these commenters went further by suggesting that proxy research services used by managers in deciding how to vote proxies should also be eligible research under the safe harbor.<sup>111</sup> All the commenters on this issue recognize that proxy services may serve administrative or other non-research purposes as well. For example, these services may assist in receiving ballots, voting, returning ballots, and reporting on the votes cast.

As discussed above, in order for an eligible research product or service to be within Section 28(e), it must provide the money manager with lawful and appropriate assistance in making investment decisions. This standard focuses on how the manager uses eligible research. It is possible that managers could determine after a careful analysis that certain proxy products that contain reports and analyses on issuers, securities, and the advisability of investing in securities may be eligible research that may provide managers with lawful and appropriate assistance in investment decision-making. In contrast, we do not believe that eligible research that assists a manager in deciding how to vote proxy ballots provides the manager lawful and appropriate assistance in making decisions about investments for his clients.

In view of these comments, we believe that proxy services may be treated as mixed-use items, as appropriate.<sup>112</sup> Proxy service providers offer a range of products, some of which may satisfy the standards set forth in this Release for eligible “research” under the safe harbor. For example, reports and analyses on issuers, securities, and the advisability of investing in securities that are transmitted through a proxy service may be within Section 28(e).<sup>113</sup> In contrast, we believe that products or services offered by a proxy service provider that handle the mechanical aspects of voting, such as casting, counting, recording, and reporting votes, are administrative

<sup>111</sup> BNY 1; ICI; ISS; Mellon; Seward & Kissel.

<sup>112</sup> See Section III.F below for a discussion of mixed-use items.

<sup>113</sup> Proxy services may also provide corporate governance research and corporate governance rating services. As discussed above, these products and services may be eligible research under Section 28(e) to the extent that they are used for investment decision-making but not in connection with voting.

overhead expenses of the manager and are not eligible under Section 28(e).

##### D. Eligibility Criteria for “Brokerage” Under Section 28(e)(3)

We recognize that to the extent that this interpretive release narrows 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>114</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>115</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.

The Proposing Release discussed a “temporal” standard to distinguish between brokerage services that are related to the execution of securities transactions, which are eligible as brokerage under the safe harbor, and those that are overhead expenses, which are not. Twenty-seven commenters believe that the safe harbor should include certain products and services as eligible “brokerage.”<sup>116</sup> Many of these commenters advocated expanding the temporal standard on the front end to include pre-trade analytics<sup>117</sup> and

<sup>114</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>115</sup> 1998 OCIE Report, at 35–36, 50.

<sup>116</sup> ABA; ASIR 1; Bloomberg; BNY 1; Charles River; E\*Trade; Eze Castle; Fidelity; George 2; ICI; IMA; ISITC; Interstate Group; ITG; Mellon; Merrill; MFA; Morgan Stanley; NSCP; Rainier; Reuters; Seward & Kissel; SIA; STA; T. Rowe Price; UBS; Ward & Smith. Only two commenters stated that the proposed brokerage standard was overbroad. CFA/FD.

<sup>117</sup> Bloomberg; E\*Trade; George 2; IMA; Interstate Group; ITG; Mellon; MFA; Morgan Stanley; NSCP; Reuters; SIA; STA; UBS. In addition, Fidelity questioned whether the Commission should exclude all pre-trade services.

OMS,<sup>118</sup> and others suggested expanding it on the back end to include long-term custody.<sup>119</sup> We considered these comments and for the reasons discussed below, we do not believe that all of the products and services identified by commenters fit within the proposed temporal standard, which we believe reflects an appropriate interpretation of the scope of “brokerage” services under Section 28(e). As clarified above, we have determined that market research (which includes pre- and post-trade analytics, including trade analytics transmitted through OMS) may be eligible research under the safe harbor. In addition, as explained below, we believe that Section 28(e) covers short-term custody, but not long-term custody. Also as explained, certain functionality provided through OMS may be eligible brokerage or research.

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>120</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 SRO rules. Clearance, settlement, and custody 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 of trade information; other exchanges of messages among broker-dealers, custodians, and institutions related to

the trade; electronic communication of allocation instructions between institutions and broker-dealers; routing settlement instructions to custodian banks and broker-dealers’ clearing agents; and short-term custody related to effecting particular transactions in relation to clearance and settlement of the trade. Similarly, comparison 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>121</sup>

#### 1. Temporal Standard

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>122</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 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 or trade analytical software that relates to the subject matter of the

statute before an order is transmitted may fall within the research portion of the safe harbor, but not the brokerage portion of the safe harbor.<sup>123</sup>

Under this temporal standard, communications services related to the execution, clearing, and settlement of securities transactions and other functions incidental to effecting securities transactions, *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 used to route orders to market centers, software that provides algorithmic trading strategies, and software used to transmit orders to direct market access (“DMA”) systems are within the temporal standard and thus are eligible “brokerage” under the safe harbor.<sup>124</sup>

#### 2. Ineligible Overhead

On the other hand, hardware, such as telephones or computer terminals, including those used in connection with OMS and trading software, 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. In addition, software functionality used for recordkeeping or administrative purposes, such as managing portfolios, and quantitative analytical software used to test “what if” scenarios related to adjusting portfolios, asset allocation, or for portfolio modeling (whether or not provided through OMS) do not qualify as “brokerage” under the safe harbor because they are not integral to the execution of orders by the broker-

<sup>121</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).

<sup>122</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.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”).

<sup>123</sup> See *supra* text accompanying notes 104–105 for discussion of market research that may be eligible under Section 28(e).

<sup>124</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.

We understand that OMS may include trading software used to route orders, provide algorithmic trading strategies, or transmit orders to DMA systems or provide connectivity to this software. Accordingly, these aspects of the OMS may be eligible brokerage.

<sup>118</sup> ASIR 1; BNY 1; Charles River; Eze Castle; ICI; IMA; Interstate Group; ISITC; ITG; Mellon; Morgan Stanley; NSCP; Rainier; STA; T. Rowe Price; UBS; Ward & Smith.

<sup>119</sup> ASIR 1; Merrill; Morgan Stanley; NSCP; SIA; STA. Commenters also suggested that the safe harbor should include the following products and services as eligible brokerage: advice on market color (ABA; BNY 1; ITG; Merrill; Seward & Kissel; SIA; UBS) and indications of interest (ABA; Merrill; SIA; UBS); capital commitment (BNY 1; SIA; UBS); and prime brokerage services (including extending stock loans and margin) (UBS).

<sup>120</sup> 15 U.S.C. 78bb(e)(3)(C).

dealers, *i.e.*, they fall outside the temporal standard described above. Further, managers may not use client commissions under the safe harbor to meet their compliance responsibilities,<sup>125</sup> such as: (i) Performing compliance tests that analyze information over time in order to identify unusual patterns, including for example, an analysis of the quality of brokerage executions (for the purpose of evaluating the manager's fulfillment of its duty of best execution), an analysis of the portfolio turnover rate (to determine whether portfolio managers are overtrading securities), or an analysis of the comparative performance of similarly managed accounts (to detect favoritism, misallocation of investment opportunities, or other breaches of fiduciary responsibilities); (ii) creating trade parameters for compliance with regulatory requirements, prospectus disclosure, or investment objectives; or (iii) stress-testing a portfolio under a variety of market conditions or to monitor style drift. Additionally, trade financing, such as stock lending fees, and capital introduction and margin services are not within the safe harbor because these services are not sufficiently related to order execution.<sup>126</sup> 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>127</sup> The products and services described in this paragraph are properly characterized as "overhead," *i.e.*, part of the manager's cost of doing

business, and are ineligible under Section 28(e).

### 3. Custody

Several commenters asked the Commission to clarify that custody is within the safe harbor,<sup>128</sup> and several of these commenters advocated broadly including long-term custody in Section 28(e), arguing that the statute explicitly references custody without limitation.<sup>129</sup> On its face, the plain language of the statute limits the scope of the safe harbor to custody that is incidental to effecting securities transactions. We believe that short-term custody related to effecting particular transactions and clearance and settlement of those trades fits squarely within the statute because it is tied to processing the trade between the time the order is placed and settlement of the trade. In contrast, long-term custody is provided post-settlement and relates to long-term maintenance of securities positions. Further, we understand that many money managers and their clients consider long-term custody to be a direct benefit to the advisory client and custody fees to be client expenses. In fact, advisory clients, rather than money managers, typically enter into contractual arrangements directly with custodians for their services, and many advisory clients pay for their own long-term custody.<sup>130</sup> We believe this is a healthy approach that provides transparency. Common industry practice is that financial firms that do not execute transactions for the client at all (*e.g.*, custodian banks) provide this service, which has no relationship to, and cannot be considered incidental to, effecting securities transactions. Therefore, we believe that custodial services, such as long-term custody and

custodial recordkeeping, provided in connection with accounts after clearance and settlement of transactions, are not incidental to effecting securities transactions and are services provided to the adviser's client, for the benefit of the client. As such, payment for a client's long-term custody and custodial recordkeeping with that client's commissions does not implicate Section 28(e).<sup>131</sup>

### E. Lawful and Appropriate Assistance

In order for a product or service to be within the safe harbor, eligible research 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>132</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 assistance to the money manager in performing his investment decision-making responsibilities.<sup>133</sup>

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.

### F. "Mixed-Use" Items

As discussed above, the 1986 Release introduced the concept of "mixed use."<sup>134</sup> Where a product or service 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>135</sup> The 1986 Release

<sup>125</sup> For example, to the extent that money managers use trade analytics, including trade analytical software to test "what if" scenarios related to adjusting portfolios, asset allocations, or portfolio modeling, or OMS 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 as the duty of best execution or for other internal compliance purposes, the trade analytical software or OMS is a mixed-use product, and managers must use their own funds to pay for the allocable portion of the cost of the software or OMS that is not within the safe harbor because it is attributable to purposes outside Section 28(e) such as for internal compliance.

<sup>126</sup> Often, advisory clients pay their own trade financing costs, which provides transparency that is beneficial to investors and does not necessarily implicate Section 28(e).

<sup>127</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>128</sup> ASIR 1; Merrill; Morgan Stanley; NSCP; Schwab; SIA; STA; UBS.

<sup>129</sup> Merrill; Schwab; SIA. In addition, UBS argued that the temporal standard is too narrow because the standard would exclude some important services, such as custody, that take place after settlement.

<sup>130</sup> See, *e.g.*, Phyllis Feinberg, "Takeaway Game": Some Custody Banks Create 2-Tiered Bidding System For Old, New Clients, Pensions and Investments, Dec. 8, 2003, at 1 (discussing services and fees custodial banks charge their clients, such as Indiana State Teachers' Retirement System or the New Mexico Board of Finance). In addition, registered investment companies must disclose the amount of fees and expenses paid in connection with custody of investments. See Form N-1A, Item 23(g) (Registered investment companies must attach custodian agreements and depository contracts concerning the fund's securities and similar investments, including the schedule of remuneration, as an exhibit to the registration statement.); Regulation S-X 210.6-07 (requiring that registered investment companies describe in the statement of operations the total amount of fees and expenses in connection with custody of investments).

<sup>131</sup> In some cases, we understand that advisory clients may pay for long-term custodial services through directed brokerage. See discussion of directed brokerage, *supra* note 27.

<sup>132</sup> See 1998 OCIE Report, at 20.

<sup>133</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.F.

<sup>134</sup> See 1986 Release, 51 FR at 16007.

<sup>135</sup> *Id.* at 16006-07.

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 so as to be able to make the required good faith determination.<sup>136</sup> Moreover, the allocation determination itself poses a conflict of interest for the money manager that should be disclosed to the client.<sup>137</sup> It appears that, in practice, some managers may have made questionable mixed-use allocations and failed to document the bases for their allocation decisions.<sup>138</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>139</sup> The Proposing Release asked whether the Commission should provide additional guidance on the allocation and documentation of mixed-use items.<sup>140</sup>

Twenty-seven commenters submitted comments that touched upon the concept of mixed use.<sup>141</sup> Most of those commenters endorsed the mixed-use concept by recommending that the Commission consider particular products as mixed-use items.<sup>142</sup> For example, commenters indicated that the following products and services may be mixed-use products: trade analytical software (which may sometimes be put to administrative use);<sup>143</sup> proxy voting services;<sup>144</sup> and OMS.<sup>145</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>146</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>147</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>148</sup>

#### *G. 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>149</sup> None of the commenters questioned the good faith determination requirement under the safe harbor. 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>150</sup>

<sup>146</sup> As noted above, this interpretation replaces Sections II and III of the 1986 Release.

<sup>147</sup> 1986 Release, 51 FR at 16006. The Commission may further address the documentation of mixed-use items at a later time.

<sup>148</sup> In allocating costs for a particular product or service, a money manager should make a good faith, fact-based analysis of how it and its employees use the product or service. It may be reasonable for the money manager to infer relative costs from relative benefits to the firm or its clients. Relevant factors might include, for example, the amount of time the product or service is used for eligible purposes versus non-eligible purposes, the relative utility (measured by objective metrics) to the firm of the eligible versus non-eligible uses, and the extent to which the product is redundant with other products employed by the firm for the same purpose.

<sup>149</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 6.

<sup>150</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

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 investment 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.<sup>151</sup> 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 or client referrals.<sup>152</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 been simply copied, repackaged, or aggregated, the money manager must make a good faith determination that any additional commissions paid in respect of such copying, repackaging, or aggregation services are reasonable. Finally, where a broker-dealer also offers its research for an unbundled price, that price should inform the money manager as to its market value

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>151</sup> If the money manager seeks the protection of the safe harbor, he or she should take care to analyze whether products and services provided by a broker-dealer and used in connection with advised accounts satisfy the eligibility and use standards for the safe harbor.

<sup>152</sup> Rule 12b-1(h) under the Investment Company Act prohibits 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>136</sup> *Id.*

<sup>137</sup> *Id.* at 16006 n.13.

<sup>138</sup> 1998 OCIE Report, at 32-34.

<sup>139</sup> *Id.*

<sup>140</sup> See Proposing Release, Question 8.

<sup>141</sup> AmBankers; Bloomberg; BNY 1; CAPIS; CFA Institute; DOL; E\*Trade; IAA; ICI; IMA; Interstate Group; ISITC; ISS; ITG; Mellon; Merrill; MFA; Morgan Stanley; NSCP; Rainier; Schwab; Seward & Kissel; SIA; STA; T. Rowe Price; UBS; Ward & Smith.

<sup>142</sup> Bloomberg; BNY 1; CAPIS; CFA Institute; DOL; E\*Trade; IAA; ICI; IMA; Interstate Group; ISITC; ISS; ITG; Mellon; Merrill; Rainier; Seward & Kissel; SIA; T. Rowe Price. The remaining eight commenters endorsed the concept of mixed use with little discussion. AmBankers; MFA; Morgan Stanley; NSCP; Schwab; STA; UBS; Ward & Smith.

<sup>143</sup> Bloomberg; E\*Trade; IAA; Merrill; SIA.

<sup>144</sup> ASIR 1; BNY 1; IAA; ICI; ISS; Mellon; Seward & Kissel.

<sup>145</sup> BNY 1; CAPIS; IAA; ICI; IMA; Interstate Group; ISITC; ITG; Mellon; Merrill; Morgan Stanley; Rainier; SIA; T. Rowe Price.

and help the manager make its good faith determination.

#### H. Third-Party Research

The Proposing Release asked whether the Commission's discussion of third-party research offered sufficient guidance in this area.<sup>153</sup> Regarding third-party research, several commenters expressly endorsed the Commission's view that independent research providers should be accorded equal treatment with proprietary research providers.<sup>154</sup> None of the commenters disputed this point. Accordingly, we reiterate our views on this issue below.

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 the advised accounts. We believe that the safe harbor encompasses third-party research and proprietary research on equal terms.

#### I. Client Commission Arrangements Under Section 28(e)

The Proposing Release asked whether the Commission's discussion of arrangements under Section 28(e) offered sufficient guidance in this area.<sup>155</sup> We received a substantial number of comments on industry practices related to client commission arrangements under Section 28(e).<sup>156</sup> Based on these comments and for the reasons discussed below, we are modifying our interpretation of "provided by" and "effecting" under Section 28(e).<sup>157</sup> In order to determine

whether our guidance requires further clarification, we are soliciting additional comment on our revised interpretation of the safe harbor with respect to client commission arrangements under Section 28(e).

Twenty-four commenters addressed arrangements under Section 28(e).<sup>158</sup> Although some commenters supported the Commission's guidance with respect to Section 28(e) arrangements,<sup>159</sup> others expressed concern that the proposal (and, in particular, the requirement that introducing broker-dealers must perform certain minimum functions in order to "provide" research under the safe harbor) could have unwarranted and harmful policy consequences, such as reducing independent research and increasing the costs that the clients of money managers pay for brokerage and research.<sup>160</sup> Some of the commenters that objected to the proposed approach on this issue stated that some introducing broker-dealers that facilitate access to valuable research may not satisfy the minimum requirements that the Release would impose, and may have to discontinue operations. They recommended that the Commission eliminate the minimum requirements or modify them so that introducing broker-dealers can more easily satisfy them. In addition, several commenters asked the Commission to consider a broader interpretation of the "provided by" concept under Section 28(e).<sup>161</sup> These commenters argued that Section 28(e) arrangements have become more complex and less transparent than if broker-dealers were permitted to engage in these arrangements unencumbered by the requirement that the broker "effecting" the transaction also must be "providing" the research. Both groups of commenters recommended that the Commission interpret Section 28(e) to allow money managers the maximum flexibility to seek best execution and, separately, obtain good research, by

exercises investment discretion." 15 U.S.C. 78bb(e)(1) (emphasis added).

<sup>158</sup> BNY 1; Bloomberg; CL King; Commission Direct; CAPIS; E\*Trade; EuroIRP; Instinet; Interstate Group; IAA; ICI; IMA; JP Morgan 1 and JP Morgan 2; Mellon; Merrill; Morgan Stanley; NSCP; Reuters; Riedel; SIA; STA; T. Rowe Price; UBS; George 1, George 2, and George 3.

<sup>159</sup> BNY 1; George 2; Interstate; Reuters.

<sup>160</sup> Bloomberg; CAPIS; E\*Trade; EuroIRP; ICI; Instinet; IMA; NSCP; JP Morgan 1; Riedel; STA; SIA; Merrill; Morgan Stanley. These commenters noted that investors' costs could increase if introducing broker-dealers must add staff and/or trading desks to fulfill the minimum requirements and raise their fees accordingly. Implicit transaction costs could also increase if these broker-dealers build trade execution capabilities so that they satisfy the four minimum criteria but are inexpert at execution.

<sup>161</sup> Commission Direct; EuroIRP; IMA; T. Rowe Price.

permitting a broker to be responsible for execution and another party to be responsible for providing eligible research.

In addition, several commenters noted that the United Kingdom's regulatory efforts in this area allow money managers to use client commissions to pay separately for trade execution by the broker-dealer that can provide the best execution and ask the executing broker-dealer to allocate a portion of the commission directly to an independent research provider or allocate a portion of the commission to a pool of "credits" maintained by the broker-dealer and from which the broker-dealer, at the direction of the money manager, may pay independent research providers, without requiring that the executing broker-dealer be legally responsible for the research.<sup>162</sup> As noted above, some commenters believed that Section 28(e) arrangements in the United States reflect a market inefficiency if the manager seeks to use client commissions to pay for research under Section 28(e) and uses this middle-man to access independent research providers.

These comments highlight the considerable variety of arrangements under Section 28(e) that the industry has developed to seek to obtain the benefits that inure to investors from best execution on orders for advised accounts and providing money managers with both third-party and proprietary brokerage and research products and services of value to the advised accounts. Based on the additional information regarding current industry practices provided by these comments and consideration of congressional intent behind Section 28(e), we are revising our interpretation of the safe harbor to address the industry's innovative Section 28(e) arrangements and permit the industry to flexibly structure arrangements that are consistent with the statute and best serve investors. We are soliciting additional comment on client commission arrangements under the safe harbor because of the many variations and complexity of these arrangements. In particular, we solicit comment on whether this guidance is sufficient to address this area.

<sup>162</sup> Commission Direct; EuroIRP; IMA; JP Morgan 1. In addition the SIA expressed concern over cross-border harmonization, noting that the Commission's four minimum functions for introducing broker-dealers may impose stricter requirements than those in place in the U.K. with respect to client commission arrangements.

<sup>153</sup> See Proposing Release, Question 5.

<sup>154</sup> AmBankers; Bloomberg; BNY 1; Investorside.

<sup>155</sup> See Proposing Release, Question 5.

<sup>156</sup> BNY 1; Bloomberg; CL King; Commission Direct; CAPIS; E\*Trade; EuroIRP; Instinet; Interstate Group; IAA; ICI; IMA; JP Morgan 1 and JP Morgan 2; Mellon; Merrill; Morgan Stanley; NSCP; Reuters; Riedel; SIA; STA; T. Rowe Price; UBS; George 1, George 2, and George 3.

<sup>157</sup> 157 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

## 1. Statutory Linkage Between “Provided by” and “Effecting”

Section 28(e) requires that the broker-dealer providing the research also be involved in effecting the trade.<sup>163</sup> The statutory linkage of the “provided by” and “effecting” elements in Section 28(e) was principally intended to preclude the practice of paying “give-ups.”<sup>164</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>165</sup> A principal concern regarding “give-ups” was that managers used them to direct client commissions to broker-dealers in exchange for providing services that benefited the money manager but had no benefit for his clients—such as to reward broker-dealers for distribution or for steering clients to the manager. The 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 on client accounts and because the broker-dealer receiving the “give-up” did nothing in connection with the securities trade to benefit investors, the Commission found that these arrangements violated the securities laws.<sup>166</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>167</sup> In the 1986 Release, the Commission departed from a strict interpretation of the “provided by” provision when it concluded 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>168</sup> We believe that both the legislative history and the Commission’s prior interpretations in this area reflect an effort to safeguard against money managers and broker-dealers using Section 28(e) arrangements as mechanisms for the manager to use client commissions to make concealed payments to a broker-dealer that did not provide any services to benefit the advised accounts.

As noted above, the industry has developed many types of Section 28(e) arrangements. Some investment managers today use these arrangements to execute trades with one broker-dealer and obtain research and other services from a different broker-dealer. In some Section 28(e) 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 arrangements, an introducing broker-dealer facilitates access to research 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 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>169</sup> In addition, several commenters endorsed arrangements similar to those that have developed in the United Kingdom, in which money managers direct broker-dealers to collect and pool client commissions that may have been generated from orders executed at that broker-dealer, and periodically direct the broker-dealer to pay for research that the money manager has determined is valuable.<sup>170</sup>

As discussed above, the legislative history behind the linkage created between the “provided by” and “effecting” statutory language in Section 28(e) indicates that Congress was concerned that the safe harbor “would be asserted as a shield behind which the give-ups and reciprocal practices which were so notorious during the late 1960’s could be reinstated.”<sup>171</sup> Since passage of the safe harbor in the 1970’s, specialization and innovation in the financial industry have resulted in the functional separation of execution and research. Thus, efficient execution venues provide good, low-cost execution while research providers offer valuable research ideas that can benefit managed accounts. We believe that this separation of functions is beneficial to the money managers’ clients, and Section 28(e) arrangements that promote functional allocation of these services are not the same as “give-ups.”

## 2. “Effecting” Transactions

Section 28(e) arrangements typically involve clearing agreements pursuant to

<sup>169</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.

<sup>170</sup> Commission Direct; EuroIRP; IMA; JP Morgan 1; T. Rowe Price.

<sup>171</sup> Joint Explanatory Statement of the Committee of Conference, Securities Acts Amendments of 1975, H.R. Conf. Rep. 94–229, at 108 (1975), reprinted in 1975 U.S.C.C.A.N. 321, 339.

<sup>163</sup> 15 U.S.C. 78bb(e).

<sup>164</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 Act 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>165</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), 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>166</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>167</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. See also 1986 Release, 51 FR at 16007; 1976 Release, 41 FR at 13679.

<sup>168</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 13678–79 (Where “fiduciaries \* \* \* [ask] the broker, retained to effect a transaction for the account of a beneficiary, to “give up” part of the commission negotiated by the broker and the fiduciary to another broker designated by the fiduciary for whom the executing or clearing broker is not a normal and legitimate correspondent[,] \* \* \* [t]he Commission does not believe that Section 28(e) would apply.”

SRO rules.<sup>172</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>173</sup> The Commission has stated that, under Section 28(e), it contemplates that in correspondent relationships, an “introducing broker-dealer would be engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to [them] by other broker-dealers for ‘research services’ provided to money managers.”<sup>174</sup> The Proposing Release identified four minimum criteria that an introducing broker-dealer must satisfy in order to be “effecting” transactions.

Based on the comments received, which are discussed above, we recognize the benefit to investors of money managers being able to functionally separate trade execution from access to valuable research. At the same time, we believe that the statutory term “effecting” requires that, in order for the money manager to use the safe harbor, a broker-dealer that is “effecting” the trade must perform at least one of four minimum functions and take steps to see that the other functions have been reasonably allocated to one or another of the broker-dealers in the arrangement in a manner that is fully consistent with their obligations under SRO and Commission rules.<sup>175</sup> The four functions

are: (1) Taking financial responsibility for all customer trades until the clearing broker-dealer has received payment (or securities), *i.e.*, one of the broker-dealers in the arrangement must be at risk for the customer’s failure to pay; (2) making and/or maintaining records relating to customer trades required by Commission and SRO rules, including blotters and memoranda of orders; (3) monitoring and responding to customer comments concerning the trading process; and (4) generally monitoring trades and settlements.<sup>176</sup> In addition, of course, a broker-dealer is effecting securities transactions if it is executing, clearing, or settling the trade.

### 3. Research Services Must Be “Provided by” the Broker-Dealer

Section 28(e) requires that the broker-dealer receiving commissions for “effecting” transactions must “provide” the 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>177</sup> The Commission

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. No. 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.*, 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 to its customers. *See, e.g.*, NASD Rule 2320; NASD Notice to Members 01–22 (Apr. 2001).

<sup>176</sup> *See* 1986 Release, 51 FR at 16007, citing SEI Financial Services Co., No-Action Letter (Dec. 15, 1983), in which the introducing broker in a correspondent relationship performed these functions.

In particular, one of the broker-dealers to the Section 28(e) arrangement must be aware of and monitor daily trading activity of customers even where the money manager sends orders directly to (and only to) the clearing broker.

<sup>177</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”).

also has clarified that research provided in third-party arrangements is eligible under Section 28(e) even if the money manager participates in selecting the research services or products that the broker-dealer will provide.<sup>178</sup> In addition, the Commission has stated that the third party also may send the research directly to the broker-dealer’s customer.<sup>179</sup> In the Proposing Release, the Commission restated its previous view that the broker-dealer must have the legal obligation to pay for the research in order to be considered “providing” the brokerage and research services under Section 28(e).<sup>180</sup> We continue to believe that a broker-dealer that is legally obligated to pay for research is “providing” research under the safe harbor. In addition, as stated above, based on the legislative history of Section 28(e), the comments received in response to the Proposing Release, and the benefits to investors of flexibility in these arrangements, we are modifying our interpretation of “provided by.”<sup>181</sup>

We believe that the safe harbor was not meant to allow money managers to use Section 28(e) arrangements to conceal the payment of client commissions to intermediaries (including broker-dealers) that provide benefits only to the money manager. In particular, we interpret Section 28(e) to be available as a safe harbor for the money manager in situations where broker-dealers use a money manager’s client commissions to pay for eligible research and brokerage for which such broker-dealer is not directly obligated to pay if such broker-dealer pays the research preparer directly and takes steps to assure itself that the client commissions that the manager directs it to use to pay for such services are used only for eligible brokerage and research. Accordingly, for purposes of Section 28(e), we believe that the following attributes will help determine whether the broker-dealer that is effecting transactions for the advised accounts has satisfied the “provided by” element, and the Section 28(e) safe harbor is

<sup>178</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>179</sup> Papilsky Release, 45 FR at 83714 n.54. *See* 1986 Release, 51 FR at 16007.

<sup>180</sup> *See* 1986 Release, 51 FR at 16007; III Report, 19 SEC Docket at 932.

<sup>181</sup> As noted above, this Release replaces Sections II and III of the 1986 Release, which include the “provided by” interpretation. *See* text accompanying note 68.

<sup>172</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>173</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>174</sup> 1986 Release, 51 FR at 16007, quoting Data Exchange Securities, No-Action Letter (Apr. 20, 1981).

<sup>175</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 laws and regulations applicable to an introducing broker or a clearing

available to a money manager;<sup>182</sup> (i) the broker-dealer pays the research preparer directly; (ii) the broker-dealer reviews the description of the services to be paid for with client commissions under the safe harbor for red flags that indicate the services are not within Section 28(e) and agrees with the money manager to use client commissions only to pay for those items that reasonably fall within the safe harbor;<sup>183</sup> and (iii) the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.<sup>184</sup>

#### 4. Legal Obligations of Parties to Section 28(e) Arrangements

The Proposing Release stated that parties to arrangements under Section 28(e) must determine whether they are contributing to a violation of law, including whether the involvement of other parties is appropriate.<sup>185</sup> Commenters expressed concern that this

<sup>182</sup> In Section 28(e) arrangements involving multiple broker-dealers, at least one of the broker-dealers (but not necessarily all) must satisfy the requirements for "effecting" transactions and "providing" research.

<sup>183</sup> In all Section 28(e) arrangements, including those in which the broker-dealer is legally obligated to pay for the research, the broker-dealer may be subject to liability for aiding and abetting violations by money managers where the broker-dealer pays for services that are not within Section 28(e). 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); *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.*, Litigation Release No. 15664, 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); *SEC v. Galleon Capital Mgmt.*, Litigation Release No. 14315, 57 SEC Docket 2593 (Nov. 1, 1994).

<sup>184</sup> A broker-dealer would need to satisfy the "effecting" and "provided by" elements of Section 28(e) only where the money manager seeks to operate within the safe harbor. If the money manager is operating in part outside of the safe harbor, the broker-dealer would need to satisfy the "effecting" and "provided by" elements only with respect to the portion of the money manager's business for which the manager seeks to operate within the safe harbor.

Prompt payment is relevant to the determination of whether the broker-dealer has "provided" research because it assures that the research and the payment are linked, thereby preserving the statutory language requiring that the broker-dealer that "effects" the transactions for the advised accounts "provides" the research.

<sup>185</sup> Exchange Act Release No. 52635 (Oct. 19, 2005), 70 FR 61700 (Oct. 25, 2005).

statement imposed heightened responsibility on money managers and broker-dealers.<sup>186</sup> To clarify, the Commission intends only to remind parties to Section 28(e) arrangements that, under existing law, money managers may be subject to liability under federal securities laws, ERISA, and state law, and broker-dealers may be subject to liability if they aid and abet another person's violation of a provision of the securities laws.<sup>187</sup> For example, if a broker-dealer knows that a money manager has represented to its clients that he will operate solely within Section 28(e),<sup>188</sup> and the adviser asks the broker-dealer to pay for office furniture and computer terminals, which under this release are not eligible under the safe harbor, the broker-dealer may risk aiding and abetting liability.

#### IV. Request for Comments

The Commission will consider further comment on evolving developments in connection with industry practices with respect to client commission arrangements under the safe harbor identified in Section III.I of this Release to evaluate whether additional guidance might be appropriate in the future. Based on any comments received, the Commission may, but need not,

<sup>186</sup> BNY 1; IAA; ICI; Mellon; NSCP; T.Rowe Price.

<sup>187</sup> See, e.g., *supra*, notes 28-31 and accompanying text; Exchange Act § 15(b)(4)(iv)(E) and Advisers Act § 203(e)(6); 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."). See also Exchange Act Release No. 11629 (Sept. 3, 1975), ("A broker which causes or assists an institution to violate a duty to the investor may be aiding and abetting a fraudulent or deceptive act or practice."); 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.").

<sup>188</sup> Advisers that are not required to operate within the safe harbor may voluntarily choose to do so, and may represent to their clients that they do so. However, if an adviser that represents to its clients that he will operate within Section 28(e) and fails to do so, the representation is false and the conduct may be a violation of Section 206 of the Advisers Act and Section 10(b) of the Exchange Act and Rule 10b-5. Advisers to mutual funds and ERISA plans must operate within the safe harbor with respect to those clients because of Section 17(e) of the Investment Company Act or ERISA. See *supra* notes 30-31 and accompanying text.

supplement the guidance in this Release in the future.

#### V. Implementation

The Proposing Release asked whether the Commission should allow market participants some period of time to implement the interpretation, and requested examples of potential implementation issues.<sup>189</sup> Fifteen commenters requested that the Commission establish a grace period for industry participants to implement the Commission's interpretative guidance of between three months<sup>190</sup> to at least one year.<sup>191</sup> Several commenters urged the Commission to issue the interpretation without any phase-in period.<sup>192</sup> Several of these commenters suggested that the Commission should delay the effectiveness of its final interpretive guidance in order to allow existing annual contracts among money managers and broker-dealers to expire<sup>193</sup> or to review their arrangements in light of the Commission's final interpretation<sup>194</sup>; others indicated that an implementation period is important to accommodate significant operational changes in the industry, including any changes necessitated in the agreements among money managers and broker-dealers.<sup>195</sup>

Since participants have relied on the Commission's prior interpretations, the Commission believes that they should be entitled to continue to rely on them for a period of time. We believe that, considering the views expressed in the comment letters, an appropriate period for market participants to continue to rely on the Commission's prior interpretations is six months. The interpretation set forth in this Release is effective immediately upon its publication in the **Federal Register**, on July 24, 2006. Market participants may continue to rely on the Commission's prior interpretations for six months following the publication of this Release in the **Federal Register**, that is, until January 24, 2007.

#### List of Subjects in 17 CFR Part 241 Securities.

<sup>189</sup> Proposing Release, Question 10.

<sup>190</sup> T. Rowe Price.

<sup>191</sup> CAPIS; IAA; IMA; Mellon; Merrill; NSCP; Seward & Kissel; SIA; UBS. Three commenters recommended six months. BNY 1; George 2; ITG. Two commenters suggested that the Commission provide the industry an unspecified "reasonable" period of time within which to comply with the Commission's interpretation. Charles River; E\*Trade.

<sup>192</sup> Investorside; Reuters.

<sup>193</sup> CAPIS; IAA; Mellon; Merrill; NSCP; Seward & Kissel.

<sup>194</sup> BNY 1; ITG.

<sup>195</sup> SIA; UBS.

**Amendments to the Code of Federal Regulations**

■ For the reasons set out in the preamble, the Commission is amending Title 17, chapter II of the Code of Federal Regulations as set forth below:

**PART 241—INTERPRETATIVE  
RELEASES RELATING TO THE  
SECURITIES EXCHANGE ACT OF 1934  
AND GENERAL RULES AND  
REGULATIONS THEREUNDER**

Part 241 is amended by adding Release No. 34-54165 and the release

date of July 18, 2006 to the list of interpretive releases.

Dated: July 18, 2006.

By the Commission.

**Nancy M. Morris,**

*Secretary.*

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