

MEMORANDUM
SECTION 28(e) - SOFT DOLLARS

A bit of history may be required to put soft dollars and the controversy surrounding it, into perspective. Prior to 1975, before the abolition of fixed commission rates, broker dealers competed by adding a number of services packaged into the commission being charged (bundled services). This bundle of services included research. When rates were deregulated, Congress decided to allow money managers to continue paying for research through commission dollars in a bundled manner, hence - §28(e), the safe harbor for soft dollars.

The best thing that can be said about soft dollars is that it supports independent research firms, thus providing the market with information it would not otherwise get. The bad part is that it mixes the cost of research with the costs of trading and clouds the transparency that the market place has been demanding. The investor ends up paying the costs no matter what (either in commissions or in an administrative fee), but using soft dollars can obfuscate an accurate analysis of costs. Whether soft dollars are good or bad or if they will continue to be used is a discussion for another day.

The questions have been flying since the SEC met on July 12, 2006 to decide if they were going to make any revisions to the soft dollar rules: Can we still use soft dollars? What is Research? Can I pay for a conference using soft dollars? Is my computer covered by 28(e)?

The SEC issued an interpretive memo on October 19, 2005 which responded to these and many other issues regarding soft dollars. It was the third interpretation memo issued on this subject (the first in 1975 accompanied the deregulation of commissions; the second in 1986 trying to clarify some of the issues). Based on the comments the SEC received from the industry, and its own investigation, the July 12th meeting basically confirmed that this 2005 memo was the official interpretation.

Lets start at the beginning: What is research? The eligibility criteria that govern “research services” are in §28(e)(3) of the Exchange Act:

For the purposes of the safe harbor, a person provides...**research services** if (s)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 **analysis** and **reports** concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts...¹

Advice, Analysis and/or Reports are the basic elements of 28(e). The SEC interprets that to mean that these items must reflect **substantive content** – **the expression of reasoning and knowledge**. Quantitative analytical software and software that provides analyses of securities portfolios would be eligible if they reflect the expression of reasoning and knowledge related to the subject matter included. **Based on this definition, the Abel/Noser TradeZoom© product and related Transaction Cost Analysis are covered by 28(e)**. Seminars and conferences where the content satisfies the criteria would also be eligible; *but not* the attendant expenses such as flight, hotel and meals. Basically, the means of communicating that expression of reasoning (print, computer, live, etc) is not the issue and is also not covered.

It is for that reason that a money manager’s rent, computers, furniture, telephones, etc. are not covered under 28(e). However, with that said, 28(e) only governs ERISA funds. It has been argued for many years, that plans or firms that are not covered by ERISA, only have to disclose their use of soft dollars in Part II of their ADV filing which goes to every client, or somewhere in their new account or offering documents sent to their clients. The argument stated that if we tell our clients that we are using soft dollars to pay for administrative things as well as rent and phone, then it is legal, not covered by the 28(e) safe harbor, but legal.

Consultants can be paid with soft dollars, but only if it fits the narrow definition above. For instance, if it’s a consultant on administrative matters, or marketing, then it is

¹ SEC Interpretive Release No. 34-52635, Oct. 19, 2005, page 28.

NOT covered. But if the Consultant provides advice on portfolio management, for example, then it IS covered.

The SEC decided that data service providers perform legitimate research functions, and as they did in their 1986 release, continue to believe that data service is a covered activity. The key is: does it reflect substantive content – the expression of reasoning and knowledge – related to the subject matter of the statute (above).

Broker Dealers:

Under §28(e)(3)(C) of the Act, a person provides “brokerage... services” if (s)he

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.²

The key phrases in this section are “**functions incidental to...**” and “**required in connection with...**” brokerage activities. Those things are protected under the safe harbor of 28(e) that relate to the execution of securities (from first call to final confirm). The research part of 28(e) covers pre-trade activity, up to the manager’s call to the broker for execution and post trade analysis. Brokerage activity includes from that phone call to the final confirm. Using that standard, communications services related to the execution, clearing and settlement of securities transactions and other incidental functions (i.e. connectivity service, dedicated lines and order management systems) are eligible. However, these functions are NOT eligible for error trades.

Mixed Use:

There are many items that constitute mixed-use items. For instance, 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 portion allocated for use in marketing. And, the money manager must keep adequate books and records concerning allocations so as to be able to make the required

² SEC Interpretive Release No. 34-52635, Oct. 19, 2005, page 32.

good faith showing. That good faith showing includes a determination that the increase in commissions relates directly to the 28(e) eligible services and not to ineligible services that are hidden in the higher commission rate.

Provided by...:

§28(e) requires that the broker-dealer receiving commissions must “provide” brokerage or research services. If the broker receiving commissions is to pay a third party, then that broker must have a direct legal obligation to pay for such services (even though the money manager chooses the third party). The third party can supply the research services directly to the client as long as the broker dealer has the obligation to pay.

Commission Sharing:

The most common commission sharing arrangement is the introducing broker – clearing firm arrangement. In this instance, the introducing broker should be in some way involved in the execution of the orders to be eligible under 28(e) to share in commissions. Customer enters an order for execution through the introducing broker. Broker executes and sends to clearing firm. Clearing firm collects commissions and sends portion to executing (introducing) broker.

Where more than one broker dealer is involved in a commission sharing arrangement, the Commission takes the view that the “introducing broker [must be] engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker dealers for “research services” provided to money managers.³

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

- 1) the arrangement must fit within the “**effecting securities transactions**” requirement. They must be financially responsible to the clearing broker dealer for all customer trades until payment is received by clearing firm, must make or maintain

³ SEC Interpretive Release No. 34-52635, Oct. 19, 2005, page 44.

books and records relating to the customer trades that are required by the SEC and the SRO, and they must monitor and respond to customer comments regarding the trading process, and generally monitor trades and settlements.

2) a broker-dealer effecting the trade must be legally obligated to a third party producer of research or brokerage services to pay for the service ultimately provided to a money manager (the “provided by..” requirement).⁴

The unbundling of brokerage and research could ultimately affect the smaller regional broker dealers that use the model of their trading desk supporting their research. More sophisticated brokerage firms, with state of the art order management systems could retain all executions and pay the small regional firm just for research via 28(e), or the customer could pay the research directly. Either way, the regional would lose a large percentage of its execution income.

The July 12th SEC confirmation of soft dollar usage would tend to imply that soft dollars will be around for a while, although with some stringent guidelines. However, many large firms have already stopped using soft dollars (i.e. Fidelity to Lehman, etc.) I hope that this clarifies some of your questions, and I will be available to discuss this further.

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⁴ SEC Interpretive Release No. 34-52635, Oct. 19, 2005, pages 45-6.