

Below is a narrative of Joseph Cascarelli's New Jersey Legal Update podcast # 21 which was published on January 6, 2006. If you would like to listen to this or any other New Jersey Legal Update podcast please visit Stark & Stark's New Jersey Law blog at www.njlawblog.com.

Money Managers operating under the jurisdiction of the Investment Adviser Act of 1940 are subject to many fiduciary duties, one of which requires investment advisers to avoid conflicts of interest. Such a conflict arises when a money manager purchases “brokerage and research services” that either do not entirely benefit his managed account clients or only indirectly benefiting them while directly benefiting himself.

Section 28(e)¹ of the Exchange Act of 1934 creates a “safe harbor” that is intended to protect money managers against a claims of breaching client fiduciary duties when they use client funds to purchase “brokerage and research services” for their managed accounts. Since the creation of Section 28(e), there has been an ongoing dialogue between the SEC and the advisory and brokerage industries, hoping to clarify which “brokerage and research services” fall inside this “safe harbor”, and when.

Recently, the SEC released its “Commission Guidance Regarding Client Commission Practices under Section 28(e)” in an effort to respond to the industries’ call for guidance. We will focus on the main points of the SEC Guidance (hereinafter referred to as the SEC’s Interpretive Release), but will also loop in many of the comments made by industry leaders who have pointed out what they perceive to be issues still left unresolved by the SEC’s Interpretive Release.

¹ The language of Section 28(e) reads as follows:

“No person ... shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law ... solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer *an amount of commissions for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer viewed in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion.*”

Let's start with a view of the big picture. The SEC's Interpretive Release sets forth a "three prong" test for determining whether and when an adviser's use of client commission dollars to pay for "brokerage and research services" becomes eligible for "safe-harbor" protection under Section 28(e). The test goes something like this:

First, the adviser must determine that the research and brokerage services that he purchases with client commissions fall within the limits of Section 28(e)(3).

Second, the adviser must determine whether the product or service actually provides "lawful and appropriate assistance in the performance of the adviser's decision-making responsibilities".

Third, the adviser must make a good faith determination that the amount of client commissions paid to the broker/dealer for research and/or brokerage services is reasonable in light of the value or services provided by the broker.

All three conditions must be met otherwise there is no guarantee of "safe harbor", the result of which is that the money manager may be subject to a claim for breach of fiduciary duty when he purchased "research" or "brokerage" services from the broker/dealer.

It is important to understand that the SEC's focus is on "commissions". This means that the SEC's proposal takes a "sell-side" view of trading, as opposed to the "inside buy-side". This was a point made by **IMA** (or, the Investment Management Association, a UK-based membership organization representing the investment management industry). **IMA's** criticism of the SEC's Interpretive Release is that the "sell side" view is increasingly becoming an out-of-date business model. **IMA** points out that "sell side" trading does not taking into full account the emergence of the trading desk "inside buy-side firms", nor of the increased emphasis on costs rather than commissions when placing

trades, nor of the emergence of alternative trading platforms and direct market access. In short, **IMA** suggests that the SEC's proposed guidance does not address what this commenter calls the "gulf between the industry structure underlying Section 28(e) and today's reality" – referring to the changes in market structures since adoption of the Exchange Act in 1934.

We will return to this later. Right now, let's return to the SEC's "three prong test" for determining eligibility for "safe harbor" protection under Section 28(e), and take a look at the details with consideration of "research services" first, and then followed by consideration of "brokerage services".

First, "research services" purchased with client commission dollars must satisfy the definition of "brokerage and research services" as defined in Subsection (3)² of Section 28(e). This means that "research services" must first meet the threshold of being in the form of (1) ADVICE or (2) ANALYSIS or (3) a REPORT. Even if "research" complies with any one of these formats, ultimately their substantive content is subject to a "reasoning or knowledge" test, meaning that the content of such advice, analysis, or reports must relate to such things as *advice* to the *value* of securities, or *advisability* about investing in securities, and *availability* of such securities; *analyses* and/or *reports* must relate to about such things as, but not limited to, economic facts and trends, portfolio strategy, and performance of accounts.

Next, these "research services" must provide "lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities". Hence intangible items like data – more accurately, market, financial, and economic data – tend to be inside "safe-harbor" protection. Specifically, if the market data relates to stock quotes, last sales prices, trading volume, the purchase of these by a money manager

² Subsection (3) relates to: (A) "*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" and (B) "*analyses and reports* concerning issuers, industries, securities, economic facts and trends, portfolio strategy, and performance of accounts".

from a broker/dealer is protected. Financial and economic data relating to unemployment figures, inflation rates, and gross domestic product figures purchased with customer funds is likewise protected against claims of breach of fiduciary duty.

Let's look at other examples. Physical items like computers – while arguably capable of providing “lawful and appropriate assistance in the performance of investment decision-making responsibilities” – nonetheless do not reflect an expression of “reasoning or knowledge” relating to the subject matter identified in Section 28(e). Hence, computers are not considered “research” or “research services” and therefore a money manager should expect the SEC to deem his purchase of computers with client funds to be outside the “safe-harbor” protection. Ditto for the following “physical” products:

- Office furniture
- Telephone lines
- Operational overhead expenses (such as travel, entertainment, and meals associated with attending seminars)
- Business supplies
- Office equipment
- Rent
- Accounting fees
- Accounting software
- Website design
- Email software
- Internet services
- Legal expenses
- Personnel management
- Marketing
- Utilities
- Membership dues
- Professional licensing fees (even covering the cost of preparing for and taking the CFA exam is excluded)

- Software to assist administrative functions, such as back-office, operating systems, and word processing
- Computer accessories
- Computer peripherals and delivery mechanisms
- Telecommunications lines
- Transatlantic cables
- Computer cables.

These products – while arguably capable of being used for providing “lawful and appropriate assistance in the performance of investment decision-making responsibilities” – do not, according to the SEC, reflect an expression of “reasoning or knowledge” relating to the subject matter identified in Section 28(e) – that is, do not directly relate to *advice* to the *value* of securities, or *advisability* about investing in securities, and *availability* of such securities, etc. Hence, the SEC does not consider these products to be “research” or “research services”. Therefore, the purchase of these products with client funds will be outside the “safe-harbor” protection, meaning that the money manager faces risk of a breach of fiduciary claim.

Traditional research reports that analyze performance of a particular company or stock is obviously “research” and is entitled to “safe harbor” protection under Section 28(e).

What about financial newsletters and trade journals? The SEC takes the position that these *could be* eligible *if* they relate to the subject matter identified in Subsection (3) of Section 28(e). That is, if they provide as *advice* to the *value* of securities, or *advisability* about investing in securities, and *availability* of such securities, or *analyses* and/or *reports* about such things, but not limited to, economic facts and trends, portfolio strategy, and performance of accounts. Same conclusion goes for quantitative software, seminars, and conferences.

The **American Bar Association** (“ABA”) registered a comment on this point, citing that the SEC has not been particularly clear about when financial newsletters and trade

journals would be eligible under Section 28(e), citing NASD's recommendation that the threshold for "safe-harbor" eligibility is or should be based on the "breadth of circulation", distinguishing mass-media publications from more narrowly focused publications such as trade journals and financial newsletters. The **ABA** points out that the legal standard in Section 28(e) is one of "substantive content", not size of circulation. The **ABA** suggests that further guidance from the SEC would be helpful in connection with financial newsletters and trade journals. The **ABA** wants the SEC to focus – not on whether a publication has broad circulation – but rather on whether the substantive content of financial newsletters and trade journals assists money managers in making informed investment decisions. If so, then financial newsletters and trade journals should enjoy "safe harbor" protection, according to the **ABA**.

What about analyses of account performance? This is interesting because it may be counter-intuitive. You might quickly draw the conclusion that account performance analyses are always "research". But not necessarily, according to the SEC. If the analysis is used for *marketing purposes*, then the analysis fails the "lawful and appropriate assistance in investment decision-making" test – meaning, it is outside the protection of "safe-harbor" provisions of Section 28(e) and the money manager who purchases this service with client commissions and uses it for marketing will risk facing a breach of fiduciary duty claim.

What about consultant services? Again, the answer is maybe yes, but maybe no. It depends. If the consultant service provides advice with respect to portfolio strategy, then this service is considered "research" and its purchase with client commission dollars will be inside "safe-harbor" protection. However, if consultant service relates to the money manager's internal management or operations, then it is not considered "research" and is outside the "safe-harbor" protection and the money manager who purchases this service with client commissions and uses it for marketing will risk facing a breach of fiduciary duty claim.

Let's turn the discussion to "brokerage services". Specifically, the SEC sees Section 28(e)(3)(c) as creating a safe harbor for *only those* brokerage services that are limited "effecting securities transaction" and "performing functions incidental" to effecting securities transactions (such as clearance, settlement, and custody), or "required" for carrying out SEC and SRO rules. Thus, in order for these to be within the "safe-harbor" protection of Section 28(e), brokerage products and services must relate to 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 in time at which funds or securities are *delivered or credited* to the advised account. This is the SEC's so-called "temporal standard".

Under this temporal standard, the following communication services relating to execution, clearing, and settlement of securities transactions would be entitled to "safe-harbor" protection:

- Connectivity service between the money manager and the broker/dealer and other relevant parties such as custodians, such as:
 1. Dedicated lines between the BD and money manager's order management systems.
 2. Lines between the BD and order management systems operated by third party vendors
 3. Dedicated lines providing direct dial-up service between a money-manager and the trading desk at the BD.
 4. Message services used to transmit orders to BDs for execution.

Services that fall outside the SEC's "temporal standard" – because they are deemed not sufficiently related to order execution – and therefore not entitled to "safe-harbor" protection include:

- Order Management Systems used by money managers to manage their orders.
- Trade analytics
- Surveillance systems

- Compliance Mechanisms
- Error Correction Trades

The SEC's position on these services has sparked considerable volume of comment from industry professionals, starting with their considerable concern over what they believe is too narrow a time-line built into the SEC's "temporal standard". Let's take a look at some of these comments.

UBS Securities ("UBS") argues that the SEC should not adopt a "temporal standard" for Section 28(e) "safe-harbor" treatment with respect to brokerage services relevant to execution of a trade. Instead, **UBS** argues for a "reasonably related" standard. That is, **UBS** urges the SEC to allow brokerage services "reasonably related" to execution of a trade, such as a money manager's "*pre-order communications*" with the broker/dealer "*in anticipation of placing the order*", should be included in the "safe-harbor".

The **Securities Industry Association** ("SIA") concurs, pointing out that the SEC's "temporal standard", as proposed, is inconsistent with the Financial Services Authority's ("FSA") rules on client brokerage. The FSA is the UK's securities regulator, and their position is that "execution" begins "at the point in time when the investment manager makes an investment or trading decision". The **SIA** points out that the SEC's "start and end time" for securities trades fails to take into account the ongoing relationship between the broker/dealers and their customers.

More to the point, the **Investment Management Association** ("IMA", a UK-based membership organization representing money managers) suggests that the SEC's "temporal standard" time-line begins too late – meaning, the SEC standard omits the fact that in recent years, more often than not, it is the trading desk in the portfolio management firm that is choosing both *how* and *where* to place the trade. This event can, and generally does, take place outside the time-line of the SEC's "temporal standard".

As **ITG Inc.** points out, the simple telephone call in the “old days” between money manager and the executing BD has, today, given way to sophisticated trading and analytical technologies employed directly by the broker effecting the trade or provided by the money manager. Information and advice is being communicated by the broker/dealer prior to the money manager’s direction to a broker to execute a trade, or even in the midst of a multi-faceted trade.

These comments from **IMA**, **ITG**, and **SIA**, and others suggest that, when “effecting a securities transaction or trade”, the communication between money manager and broker-dealer involves a *continuum* that is much broader than the time-line in the SEC’s “temporal standard”. In the opinion of these industry professionals, the SEC’s time-line – starting with placing a trade order with the BD and ending with delivery of funds or securities – is much too narrow and excludes certain “*pre-order communications*” with the broker/dealer “*in anticipation of placing the order*”. It is the opinion of many industry professionals that these “pre-order communications in anticipation of placing the order” should constitute legitimate “brokerage services” for purposes of the Section 28(e) safe-harbor.

What about brokerage services used to “perform functions *incidental* to effecting securities transactions” -- that is, clearance, settlement, and custody? The SEC’s position has sparked considerable comment from industry professionals when the SEC suggests that four (4) minimum requirements must be met in order for commission sharing arrangements (or “CSA”) to enjoy safe-harbor protection under Section 28(e).

First, let’s state the general rule. The SEC says that the CSA must be part of a “normal and legitimate relationship” in which each BD is engaged securities activities *of a more extensive nature than simply receiving commissions* paid to it by the other BDs for services provided to money managers. Assuming that this threshold is met, the following conditions must be met in order for the CSA to enjoy safe-harbor protection:

- The introducing BD must be financially responsible to the clearing BD for all customer trades until the clearing BD has received payment, that is, the introducing BD must be at risk to the clearing BD to cover a customer's failure to pay for the trade.
- The introducing BD must make and maintain records required by the SEC & SRO rules.
- The introducing BD must monitor and respond to customer comments concerning the trading process. And,
- The introducing BD must generally monitor trades and settlements.

Instinet (one of the largest independent providers of research and brokerage services) expresses concern that imposing these four (4) requirements on introducing BDs could result in a *de facto* regulatory prohibition of certain CSAs already in existence, and possibly even change existing law interpreting the “effecting securities transaction” element in Section 28(e) without any basis in the legislative history of that section of the statute. **Instinet** points out the main problem: SRO Rules do not currently specify that certain “functions *incidental* to effecting securities transactions” must be assigned to introducing BDs in order for a CSA to be legitimate. In fact most CSAs assign only minimal responsibilities to the introducing BD – consistent with traditional role of the introducing BD performing the limited role as “salesman” who brings the order to the clearing BD who then executes, settles, confirms, and clears the trade. **Instinet** says that these four requirements are substantial duties marking a radical department from industry practice and existing law.

J.P. Morgan points to a practical problem: Exactly *when and how* should the introducing BD perform these functions? **J.P. Morgan** suggests that the SEC Guidance does not say. Arguably, the introducing BD may be required to perform all four functions at some point during the SEC's “temporal process” ... beginning “when the money manager communicates with the broker-dealer of the purpose of transmitting an order for execution” and ending “when funds or securities are delivered or credited”. **J.P. Morgan**

gives this example: Say a money manager uses a CSA to allocate commissions some time after the trade settles (e.g., on a monthly or quarterly basis). Say the introducing BD is not notified of a trade executed today; instead he is notified a month later when commissions are allocated. Under this scenario, it is not clear *how* the introducing BD, upon receipt of these commissions, would be able to ensure that it has performed all of the SEC's required four functions. It is not clear what steps, if any, can be taken by the introducing BD *at this later point in time* to monitor trade or otherwise take financial responsibility for the trade.

Under this scenario, a money manager using a CSA to provide periodic allocations of client commissions would not, according to **J.P. Morgan**, be able to rely on Section 28(e) as a safe-harbor. This, in turn, compromises the money manager who sought to make use of the CSA. Now the money manager finds himself outside the protection of the "safe-harbor". The SEC's position on Commission Sharing Arrangements therefore poses risks to both the introducing BDs as well as to money managers.

While traditional post-trade brokerage services, such as (1) post-trade matching; (2) exchange of messages among BDs, custodians, and institutions; (3) electronic communication of allocation instructions between institutions and broker/dealers; and (4) routing settlement instructions to custodian banks and BD clearing agents, are eligible for safe-harbor treatment, there appears to be serious questions whether all or most commission sharing arrangements will always be similarly treated.

This trading related issue brings up another topic that was heavily commented on by industry professionals, namely, "trading analytics". As previously stated, the SEC considers Office Management Systems (OMS) used by money managers to manage their trade orders to fall outside the time-line of the SEC's "temporal standard". The SEC also takes the position that OMS systems are not sufficiently related to trade order execution to be entitled to safe-harbor protection. Industry professionals disagree, stating there is

need for more clarification of the status of trade analytical products and services as legitimate “research” within the safe –harbor protection.

ITG Inc. states that there are many aspects to OMS systems that necessarily constitute brokerage, citing the fact that modern OMS systems provide electronic connectivity to brokers, broker provided algorithmic trading systems, markets, and other execution functionalities among brokers and execution venues, thereby affording money managers the ability to trade from the OMS. At a minimum, says **ITG Inc.**, OMS systems should enjoy “mixed use” status. **ITG Inc.** states: “A flat statement that OMSs do not qualify as ‘brokerage’ however, as was done by the Commission in the Proposing Release, appears to us to be unwarranted given the many ‘brokerage’ (and in some cases, ‘research’) applications of OMSs.” Concurring with **ITG Inc.**, **SIA** has commented that OMS “systems are so integrated and interrelated with order execution systems and market data and other research services, that there is no bright line between the various components of these systems.” For this reason, **SIA** urges the SEC to recognize that OMS systems should be eligible for safe-harbor protection to the extent that they are “subsumed” by brokerage and research services that are eligible for safe-harbor treatment. In short, **SIA** argues that OMS systems be accorded “mixed-use” allocation.

At the very beginning of our discussion, we pointed out that one commenter, **IMA** (the UK-based investment management membership group) questioned whether the SEC’s Guidance relates to an out-of-date business model, citing that the SEC’s model does not take into full account the increased emphasis on costs rather than commissions when placing trades.

Another industry professional, **ITG Inc.** concurs, pointing out that money managers often seek to ensure that cost analysis and “cost awareness” exist at every step of the investment cycle, from portfolio construction to pre-trade strategy planning, from execution to post trade analysis. **ITG Inc.** says that such analyses provide feedback that can be used to inform decisions at every step in the investment decision-making process.

ITG Inc. argues that analysis and trading tools allow a money manager to control cost and risk based on insights from each phase of the investment process, significantly contributing to the money manager's ability to satisfy the best execution rule. Post-trade analytical tools can assist a money manager determine the optimal way to trade securities in accordance with his investment objectives, and providing money managers with tactical and strategic measures of trading cost measurement, permitting the development of and monitoring of suitable trading cost benchmarks, and allowing adjustment to trading strategies to optimize trade execution and overall performance.

SIA agrees, citing the fact that certain post-trade analytics provide an analysis capable of confirming whether a trade execution has met or exceeded a volume average weighted price for a security, effectively operating as a "report card" helping a money manager to determine whether a broker-dealer executed the transaction in accordance his expressed direction. **SIA** argues that, even though these post-trade analytics fall outside the SEC's time-line "temporal standard", these analytical tools are an inherent part of the execution process and cannot, realistically speaking, be separated from "brokerage services". In short, post-trade analytics should be entitled to Section 28(e) safe-harbor treatment, according to these industry professionals.

The reason underlying the SEC's position that post-trade analytics should not be eligible for "safe harbor" protection seems to be tied to fact that a money manager can use post-trade analytics for marketing. While post-trade analytics may, indeed, be capable of being used for marketing purpose, **ITG Inc.** and others argue that, it can also be used for investment decision-making, and when used for investment decision-making, trade analytical tools should, at a minimum, be afforded at least "mix use" status.

A final note: there was one recurring comment repeated by most industry professionals, regarding the globalization of the securities market. Industry professionals are concerned about inconsistencies between the SEC's Guidance regarding client commission practices and the UK's FSA's regulations dealing the same topic. Industry professionals are

concerned that these regulatory inconsistencies could impeder further harmonization of U.S. and foreign markets. In short, theirs is a plea for a “consistent global approach to regulation”. In all fairness to the SEC, the American counterpart to the FSA must work within the legal constraints of the Securities Exchange Act of 1934. Just the same, industry professionals are concerned about inconsistent national regulatory systems and the cost of compliance for players in the global marketplace, where trading and money management practices are increasingly becoming more or less uniform.

Another final plea, universally repeated by those commenting on the SEC’s Guidance is that the SEC extends a grace period between the release of the SEC’s final interpretation and the date of its effectiveness. The general consensus seems to be that a period of six months to a year is needed.

There is much more to this story. Regretfully we have had to limit the scope and depth of this discussion. If you wish to review the entire SEC *Commission Guidance Regarding Client Commission Practice under Section 28(e) of the Securities Exchange Act of 1934*, [including all current comments](http://www.sec.gov/rules/interp.shtml) on the SEC’s Interpretive Rule, go to: <http://www.sec.gov/rules/interp.shtml> (Release No. 34-52635).