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MEMORANDUM

TO: Our Clients and Friends

FROM: Godfrey & Kahn, S.C.

DATE: August 23, 2006

RE: SEC Guidance Regarding "Soft Dollar" Practices

On July 24, 2006, the SEC issued an interpretive release with respect to soft dollar practices under Section 28(e) of the Securities Exchange Act of 1934. This release took into account the comments received by the SEC in response to its proposed interpretive release of October, 2005. The SEC is seeking further comment on various aspects of the guidance contained in the release. Those who wish to comment on the release have until September 7, 2006 to do so.

Section 28(e) establishes a safe harbor that allows money managers to use commissions generated by client trades to acquire "brokerage and research services" under certain circumstances without breaching their fiduciary duties to clients. The safe harbor provides generally that a money manager does not breach its fiduciary duties to act in the best interests of clients 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.

The interpretive release seeks to clarify the scope of brokerage and research services as well as client commission arrangements covered by the safe harbor. Over the past thirty years, the SEC has issued several releases interpreting the Section 28(e) safe harbor, but has determined to provide further guidance now because of evolving market practices and technological advances. The release specifically provides guidance with respect to:

the appropriate framework for analyzing whether a particular product or service falls within the "brokerage and research services" safe harbor;

the eligibility criteria for "research";

the eligibility criteria for "brokerage";

the appropriate treatment of "mixed-use" items;

the money manager's statutory requirement to make a good faith determination that the commissions paid are reasonable; and

the treatment of third-party research and commission-sharing arrangements.

Furthermore, the SEC solicited additional comments regarding client commission arrangements given evolving developments in the industry.

Each of these items is discussed below.

I. Framework for Determining Whether a Product or Service Falls Within the Safe Harbor

The interpretive release suggests a three-step approach to determining whether a particular product or service falls within the Section 28(e) safe harbor provision. First, the money manager must determine whether the product or service falls within the specific statutory limits of Section 28(e) (see II and III, below). Second, the manager must determine whether the product or service actually provides lawful and appropriate assistance in the performance of the manager's investment decision-making responsibilities. Where a product or service has a mixed use, a manager must make a reasonable allocation of the costs of the product according to its use. Third, 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.

II. "Research Services"

To qualify as research services under Section 28(e), a product or service must constitute "advice," "analyses" or "reports" within the meaning of Section 28(e) and its subject matter must fall within the specified categories. The interpretive release notes that the common element among advice, analyses, and reports is the expression of reasoning or knowledge. Products or services that do not reflect the expression of reasoning or knowledge, including products with tangible or physical attributes, are not eligible under the safe harbor. A money manager's overhead expenses, therefore, do not constitute research and are not eligible for the safe harbor. Likewise, computer hardware and the means to deliver eligible research (i.e., communication equipment) would not be eligible for the safe harbor. However, traditional research reports, certain financial newsletters and trade journals and quantitative analytical software would be eligible for the safe harbor. It should be noted that the SEC does not believe that Section 28(e) should protect a money manager's purchase of publications that are mass-marketed. Indicia of 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. The SEC considers mass-marketed publications as overhead expenses of money managers.

For a product or service to fall within the safe harbor, it must not only satisfy the definition of research service, but it must also be used by the money manager to provide lawful and appropriate assistance in making investment decisions. This latter test focuses on how the

money manager uses the eligible research, to ensure that client commissions are only used to help the money manager with investment decision making. For example, certain proxy services would be eligible for the safe harbor if the product or service contained reports and analyses on issuers, securities, and the advisability of investing in securities. In contrast, the SEC believes that products or services offered by a proxy service provider that handle the mechanical aspects of voting are administrative overhead expenses of the manager and are not eligible under Section 28(e). Proxy services may, therefore, have elements that qualify as "research" and other elements that constitute nothing more than administrative overhead. If that is the case, such proxy services have a "mixed use," and client commissions may be used to pay for that portion of the cost of the services allocable to eligible research.

III. "Brokerage"

Under Section 28(e), eligible brokerage products and services include not only activities required to effect securities transactions, but also functions incidental thereto (such as clearance, settlement and custody) or required by SEC or self-regulatory organization rules (such as electronic confirmation or affirmation of institutional trades in connection with settlement processing). The interpretive release also proposes a temporal standard to distinguish between brokerage services that are eligible under Section 28(e) and those products and services that are not. The release states 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. By contrast, the release notes that research services include services provided before the communication of an order.

As with research, the money manager must be able to show that the product or service provides lawful and appropriate assistance in executing investment decisions for the product or service to be eligible for safe harbor protection as brokerage.

In response to several requests by commentators to clarify that custody services are within the safe harbor, the SEC stated that it believed that short-term custody related to effecting particular transactions and clearance and settlement of those trades fits squarely within the Section 28(e) safe harbor 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. Accordingly, the SEC believes 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. Therefore, payment of a client's long-term custody and custodial recordkeeping with the client's commissions is not covered by the Section 28(e) safe harbor.

IV. Treatment of "Mixed-use" Items

The interpretive release briefly addresses the treatment of mixed-use items, but does not propose to change the industry practice established by the SEC's 1986 release on the subject. With respect to mixed-use items, money managers are required to make a reasonable allocation of the cost of the product based on its use and must keep adequate records concerning allocations in order to make the required good faith determination. Furthermore, the allocation

determination itself presents a conflict of interest for the money manager and must be disclosed to the client.

V. Money Manager's Good Faith Determination of Reasonableness

The interpretive release reaffirms that to be eligible for the safe harbor, money managers must make a good faith determination that the commissions paid are reasonable in relation to the value of the brokerage and research services provided. The burden of proof in demonstrating the good faith determination rests on the money manager.

VI. Third-Party Research and Commission Sharing Arrangements

In response to its proposed interpretive release, the SEC received many comments regarding third-party research and commission sharing arrangements. Regarding third-party research, the SEC noted that third-party research arrangements can benefit advised accounts by providing money managers with the ability to choose from a broad array of independent research products and services as well as obtain specialized research that is particularly beneficial to the advised accounts. Accordingly, the SEC stated that it believes that the safe harbor applies to third-party research and proprietary research on equal terms.

The SEC received a substantial number of comments on industry practices related to client commission arrangements under Section 28(e). The SEC noted that the comments highlighted the significant variety of arrangements under Section 28(e) that the industry has developed to seek to obtain the benefits that investors receive 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 comments, the SEC modified its interpretation of "provided by" and "effecting" under Section 28(e). The SEC is soliciting additional comment on its revised interpretation of the safe harbor with respect to client commission arrangements under Section 28(e) in order to determine whether its guidance requires further clarification.

The interpretive release still confirms that both third party research and commission sharing arrangements may qualify for the safe harbor, provided they meet the following conditions:

Third-Party Research

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

The safe harbor requires that the broker-dealer receiving the commissions must "provide" the brokerage or research services. The SEC has interpreted this to permit money managers to use client commissions to pay for research produced by someone other than the executing broker-dealer (i.e., third-party research), so long as the broker-dealer has the direct legal obligation to pay for the research. The safe harbor is available even if the money manager selects the research products or services the broker-dealer will provide, and even if the third party researcher sends the research directly to the broker's customers. The release expressly states that the safe harbor is not available

when a money manager uses the broker-dealer merely to pay an obligation that it has incurred with a third party.

The SEC believes that the following attributes will help determine whether a broker-dealer that is effecting a transaction for an advised account has satisfied the "provided by" element, and the Section 28(e) safe harbor is available to a money manager:

> the broker-dealer pays the research preparer directly;
>
> 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; and
>
> the broker-dealer develops and maintains procedures so that research payments are documented and paid for promptly.

2. "Effecting" Transactions

The safe harbor requires that the broker-dealer providing the research also be involved in "effecting" the trade. The statutory linkage of the "provided by" and "effecting" elements in Section 28(e) was originally intended to prevent "give-ups," the practice of paying a portion of the commission charged by the executing broker-dealer to an introducing broker-dealer who did nothing in connection with the security to benefit the investor, under the guise of "research." The SEC, in the 1986 release on the subject, stated that paying 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 and therefore could still fall within the safe harbor.

Commission Sharing Arrangements

The interpretive release summarizes the necessary elements for a commission sharing arrangement, under which a money manager executes trades with one broker-dealer and obtains research from a different broker-dealer, to qualify for the safe harbor as follows:

> The commission-sharing arrangement must be part of a normal and legitimate correspondent relationship in which each broker-dealer is engaged in securities activities of a more extensive nature than merely the receipt of commissions paid to it by other broker-dealers for research services provided to money managers (i.e., the "effecting" transactions requirement). At a minimum, this means the introducing broker-dealer must:
>
> > be financially responsible to the clearing broker-dealer for all customer trades until the clearing broker-dealer has received payment or securities,

make and/or maintain records relating to its customer trades required by SEC and SRO rules,

monitor and respond to customer comments concerning the trading process, and

generally monitor trades and settlements; and

The broker-dealer effecting the trade (if not providing research and brokerage services directly) must be legally obligated to a third-party producer of research or brokerage services to pay for the service ultimately provided to a money manager (i.e., the "provided by" requirement).

The proposed interpretive release of October, 2005 stated that parties to a commission sharing arrangement under Section 28(e) must determine whether they are contributing to a violation of law, including whether the involvement of other parties is appropriate. Several commentators expressed concern that this statement imposed heightened responsibility on money managers and broker-dealers. To clarify, the SEC stated that it simply intended to remind parties to Section 28(e) arrangements that, under existing law, money managers may be subject to liability if they aid and abet another person's violation of a provision of the securities laws.

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We will continue to monitor the SEC's activities for new developments. In the meantime, please do not hesitate to contact us if you have any questions.

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