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Legal Alerts

Soft Dollar Practices in 2007

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I. BACKGROUND

The term "soft dollars" refers to the use by money managers of client funds to purchase brokerage and research services. Money managers who comply with Section 28(e) of the Securities Exchange Act of 1934 have been granted a "safe harbor" from possible violations of their fiduciary duties in using client commission funds to purchase such services, even though they may not obtain the lowest possible commission rates for their clients as a result of such use. The SEC has periodically issued interpretive releases containing guidance on soft dollar practices, and its most recent and comprehensive guidance (SEC Release 34-54165 - the "Release") became effective for transactions after January 24, 2007.

While Section 28(e) by its terms applies directly to money managers, the SEC has specifically stated in the Release that broker-dealers who turn a blind eye to client soft dollar practices which are outside the safe harbor "may risk aiding and abetting liability." A specific example cited by the SEC is that of a broker-dealer who is requested by a money manager client to segregate a portion of commissions "to pay for office furniture and computer terminals," a use clearly not permitted under the safe harbor.

II. SEC GUIDANCE – SPECIFICS

A. Analyzing the Scope of "Brokerage and Research Services"

The Commission has implemented the following analysis to determine whether a product or service falls within the safe harbor: (1) the money manager must determine whether the product or service is eligible "research" under Exchange Act Section 28(e)(3)(A) or (B), or eligible "brokerage" under Section 28(e)(3)(C); (2) the manager must determine whether the eligible product actually provides lawful and appropriate assistance in the performance of the manager's investment decision-making responsibilities; and (3) the manager must make a good-faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services being provided.

B. General Criteria for "Research Services"

In assessing whether a research product or service falls within the safe harbor, a money manager must conclude it constitutes "advice," "analysis," or "reports" within the meaning of the Exchange Act. According to the Commission, "[a]n important common element among "advice," "analysis," and "reports" is that each reflects substantive content - that is, the *expression of reasoning or knowledge*." (Emphasis added). Under this framework, the Commission noted that the following (among others) would be eligible for safe harbor

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treatment: (i) traditional research reports analyzing the performance of a stock; (ii) seminars, conferences, discussions with analysts, as they specifically relate to research; and (iii) software providing analyses of securities portfolios.

C. Mass-marketed Publications

The Commission re-affirmed its earlier position that the safe harbor should not cover the purchase of mass-marketed publications as "research" material, if they are "intended for and marketed to a broad, public audience," since such publications are more appropriately considered "overhead." Moreover, the focus of the published materials and not their distribution method is determinative as to whether they are "mass-marketed." Therefore, publications which may be available over the internet, but which are targeted and marketed as specialized material for a narrow audience, could be covered by the safe harbor.

D. Market Research

The Release offers clarification on the various sources and products from which research eligible for protection under the safe harbor might be obtained. Examples include: (i) pre-trade and post-trade analytics, software, and other products that depend on market information to generate market research; (ii) research on "optimal execution venues and trading strategies"; and (iii) 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." Also, the Commission has definitively stated that the safe harbor encompasses both third-party research and proprietary research "on equal terms."

E. Data Services

Data services, including market data, may be eligible under the safe harbor "if the data reflects substantive content related to subject matter categories identified in Section 28(e)." Therefore, market data such as "stock quotes, last sale prices, and trading volumes" contain substantive content and constitute "reports concerning ... securities" under the safe harbor.

F. Items and Services Ineligible as “research”

Generally, products that do not reflect "reasoning" or "knowledge" are *not eligible* as "research" under the safe harbor. Examples of such items include, among others: (i) computer hardware and terminals and accessories, which may assist in the delivery of research; (ii) installation of telephone lines; (iii) office furniture; (iv) expenses for travel, entertainment and meals associated with attending a seminar; (v) rent; (vi) accounting fees and software; (vii) website design; (viii) email software; (ix) internet services; and (x) professional licensing fees. These items would generally be viewed as overhead costs which should not be passed on to the fiduciary clients of money managers.

G. General Criteria for “Brokerage Services"

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The SEC notes that the safe harbor covers "brokerage services" insofar as a person "effects securities transactions and performs functions incidental thereto (such as clearance, settlement, and custody) ..." The Release identifies the following "post-trade" services that are incidental to executing a transaction and thus eligible under the safe harbor as brokerage services: (i) post-trade matching of trade information; (ii) other exchanges of messages among broker-dealers, custodians, and institutions related to trades; (iii) electronic communication of allocation instructions between institutions and broker-dealers; (iv) routing settlement instructions to custodian banks and broker-dealers' clearing agents; (v) short-term custody related to effecting particular transactions in relation to clearance and settlement of trades; and (vi) comparison services required by the Commission or SRO rules.

H. Brokerage Services Defined by the Temporal Standard

Under what is commonly known as a "temporal standard," the SEC notes 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." Therefore, "communications services related to the execution, clearing, and settlement of securities and other functions incidental to effecting securities transactions" are eligible under the safe harbor. Under this standard, the Release gives the example of eligible connectivity services between a money manager and the broker-dealer and other relevant parties such as custodians, including: (i) dedicated lines between the broker-dealer and an order management system operated by the money manager or a third-party vendor; (ii) dedicated lines providing a direct dial-up service between the money manager and the trading desk at the broker-dealer; and (iii) messaging services used to transmit orders for execution. In addition, the Release refers to eligible 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 systems.

I. Overhead Costs Ineligible as Brokerage Services

The Release is clear that "overhead," which it described as "part of the manager's cost of doing business," is not eligible for the safe harbor. Accordingly, hardware such as telephones or computer terminals, or software used for recordkeeping and administrative purposes, or systems to test "what-if" trading scenarios, *do not qualify* as "brokerage" and, thus, are not eligible for the safe harbor. In addition, managers *may not* use client commissions under the safe harbor to meet their own compliance responsibilities as investment advisers or otherwise, and the costs of correcting money manager errors, obtaining financing or stock loan arrangements cannot be viewed as eligible for soft dollar usage.

J. Limitation on Custody Services as "Brokerage"

Short-term custody related to effecting particular transactions and clearance and settlement of those trades fits squarely within the safe harbor. However, long-term custody, which is "provided post settlement and relates to long-term maintenance of securities positions," does not fall within Section 28(e) according to the Commission.

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K. "Mixed-use" Items

In its Release, the Commission discusses the situation in which a product or service has a mixed use. This situation requires a manager, before assigning a soft dollar category to such product or service, to (i) make a reasonable allocation of the cost of the product according to its use; and (ii) keep adequate books and records concerning all such allocations, so as to be able to make the required good faith, fact-based showing that a portion of the cost indeed qualifies for safe harbor treatment. An example of such a mixed-use item would be proxy products and services, with the portion which provides managers with "lawful and appropriate assistance in making investment decisions" eligible under the safe harbor.

III. ADDITIONAL CONSIDERATIONS

A. Money Managers Good Faith Determination of Reasonableness

In following the guidance in the Release, managers need to be mindful that soft dollar commissions paid are "reasonable in relation to the value of the brokerage and research services received." To satisfy Section 28(e), a manager should document his or her good faith determination with the following information: (i) the service or product is eligible under the language of the statute as interpreted by the SEC; (ii) the service or product was used in performing investment decision-making responsibilities over which the manager exercises investment discretion; and (iii) the manager believes that the amount of commissions paid is reasonable in relation to the value of the research or brokerage service received. Failure to establish any one of the three criteria could remove the service or product from safe harbor treatment under Section 28(e).

B. Lawful and Appropriate Assistance

Whether a manager is providing "lawful and appropriate assistance" to his clients through soft dollar arrangements is meant to address *how* client commissions are used. For example, while using client commissions to pay for analyses of account performance may ordinarily qualify for the safe harbor, using the same analyses for marketing purposes (as opposed to investment guidance) removes it from the purview of the safe harbor.

C. Client Commission Arrangements - "Effecting" and "Providing" Arrangements

Brokerage. In recognition of trends and practicalities in today's securities markets, the Commission has moved away from prior suggestions that the broker "providing" the safe harbor brokerage services also had to be the executing agent. The Release notes that, in order to provide the industry with flexibility driven by customer demands and efficiency, and to allow better utilization of third-party brokerage services, the broker "providing" the services and the broker "effecting" the trade can be different entities. However, the broker effecting the trade must take financial and regulatory responsibility for customer trades until they are settled and must ensure that other participants fulfilling essential functions in the execution process are in fact doing so.

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Research. Similarly, in assessing whether research services qualify for the safe harbor even if not provided by the broker actually holding soft dollar commissions, the following three factors should be considered: (i) whether the broker pays the research preparer directly; (ii) whether the broker reviews the description of services to be paid for by client commissions under the safe harbor for "red flags," and (iii) whether the broker maintains procedures to document and ensure that research payments are made appropriately and promptly.

IV. CONCLUSION

The Release reflects the Commission's desire to interpret Section 28(e) in a practical and flexible manner that recognizes the realities of today's rapidly changing securities markets. However, the Release also contains specific and detailed guidelines on requirements for obtaining safe harbor status for soft dollar accounts. For both money managers and broker-dealers accepting soft dollar business, knowing and following the SEC's most recent guidance with respect to Section 28(e), and documenting their compliance efforts, are not optional.

Featured People

Sy H. Bucholz

Counsel|New York

212.965.4531 seymour.bucholz@foster.com

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