



Legal Risk Management Tip August 2006

Best Execution and Use of Soft Dollars

This is the fourth of five risk management tips addressing the process of building internal controls. **Best execution and the use of soft dollars** have always been hot topics of discussion. With new technologies and industry practices, firms are challenged by identifying conflicts and interpreting the scope and application of Section 28(e).

Section 28(e) of the Securities and Exchange Act of 1934 provides a safe harbor for investment advisers by allowing the use of client commissions to purchase certain “brokerage and research services” without breaching their fiduciary duties owed to clients. As a fiduciary, the money manager may not use client assets for its own benefit and must seek to achieve best execution for client trades. In recent years, clients have increasingly questioned whether they are truly benefiting from the use of their commissions to pay for the adviser’s brokerage and research services.

On July 24, 2006, the Securities and Exchange Commission (SEC) issued Release No. 34-54165 which provides interpretive guidance on client commission practices under Section 28(e). The following is a partial summary of the safe harbor guidance provided by the Commission.

A. Research Services

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

- 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.

B. Brokerage Services

Brokerage services are restricted to 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 transmitting an order for execution through the point at which funds or securities are delivered or credited to the advised account.

- Eligibility for safe harbor protection is governed by the criteria in Section 28(e)(3) and with the Commission’s “lawful and appropriate assistance” standard.
- Mixed-use items must be reasonably allocated between eligible and ineligible uses. The manager must keep adequate books and records concerning allocations and make a 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, the following must apply:
 1. Broker-dealers that are party to Section 28(e) arrangements must be involved in “effecting” the client’s trade. This means that the broker-dealer must execute, clear or settle the trade or perform one of the following four functions (and may allocate the other functions to another broker-dealer): (a) take financial responsibility for customer trades; (b) maintain records relating to customer trades; (c) monitor and respond to

2. customer comments concerning the trading process and/or (d) monitor trades and settlements.
3. Broker-dealers that are party to Section 28(e) arrangements must “provide” research. This occurs if the broker-dealer (a) prepares the research, (b) is financially obligated to pay for the research, or (c) is not financially obligated to pay but its arrangements have certain attributes.

In light of these guidelines, firms should re-evaluate their soft dollar practices and consider the following eight steps in evaluating their best execution.

Eight Steps for Reviewing Best Execution:

- I. Establish a definition of what best execution means to the adviser. *Risk Management Tip:* Make sure the definition is broad enough to include products such as Equity Indices.
- II. Consider all factors regarding execution, such as styles, liquidity and size of the transaction.
- III. Determine what research the adviser wants to get from soft dollars.
- IV. Consider if brokers are custodialing customer securities.
- V. Determine what products or services are outside of the safe harbor.
- VI. Establish what information the firm needs regarding alternatives available (e.g., cost, capability, etc.).
- VII. On a trade-by-trade basis, consider performing pre-trade analytics for selecting a broker-dealer.
- VIII. Consider whether the firm’s procedures are compliant and competitive. Review your security selection, selection of broker-dealers and execution times and prices.

Pro-actively reviewing your soft dollar practices in light of the Commission’s latest guidance as well as considering these eight steps towards best execution will help you to implement appropriate safeguards to serve your clients’ best interest and mitigate conflicts of interest within your firm.

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