



# SHARTSIS FRIESE LLP

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**VIA E-MAIL**

To Our Investment Adviser Clients and Other Friends:

On July 18, 2006, the SEC issued an interpretative release<sup>1</sup> (the “Release”) clarifying the scope of section 28(e) of the Securities Exchange Act. Under the so-called “section 28(e) safe harbor” (the “Safe Harbor”), an investment manager does not violate its fiduciary duty to its clients solely because it pays more than the lowest commission rate to receive brokerage and research services provided by a broker. An investment manager that does not comply with the Safe Harbor and does not adequately disclose its brokerage practices to its clients arguably might be required always to use the broker with the lowest commission rate. The Release identifies several key principles that investment managers must follow to be within the Safe Harbor.

**Summary of Changes to Current Practices.** The Release more clearly defines the boundaries of permissible “research” and “brokerage” products under the Safe Harbor, including the status of computer hardware, mass-marketed publications, market research, order management systems (“OMS”), trade analytic software and proxy voting services. See “Clarification of “Research” and “Brokerage”” below.

The Release also gives further guidance as to the method of allocating the expense of mixed-use products between uses that are permitted and not permitted under the Safe Harbor. See “Mixed-Use Products and Services” below.

Finally, the Release replaces previous SEC interpretations regarding third-party research and other commission sharing arrangements, relaxing the procedures a broker must follow to be deemed to “effect” trades and “provide” research goods and services to managers. See “Third Party Research and Other Commission-Sharing Arrangements” below.

**Managers Should Conduct Immediate Review.** Our clients’ policies and procedures generally require an annual or more frequent review of soft dollar practices. In view of the SEC’s changes to its previous soft dollar guidance summarized in this letter, we recommend that our clients now review with us whether they should change their soft dollar practices.

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<sup>1</sup> Exchange Act Release No. 54165 (July 18, 2006), available at [www.sec.gov/rules/interp.shtml](http://www.sec.gov/rules/interp.shtml).

**Clarification of “Research” and “Brokerage”.** To qualify for the Safe Harbor, client commissions must be used for “research” or “brokerage” goods or services.

**“Research”.** The Release updates the definition of “research” to mean specialized advice, analyses and reports that reflect the expression of reasoning or knowledge. The Release lists several specific examples of permissible “research”, including (1) traditional research reports, (2) discussions with analysts and meetings with corporate executives to obtain reports on the performance of a company, (3) data services (such as those that provide market data, company financial data and economic data), (4) research related to the market for securities (such as pre-trade and post-trade analytics, software and other products that depend on market information to generate market research, research on optimal execution venues and trading strategies, and advice from brokers on order execution, execution strategies, market color and the availability of buyers and sellers), (5) tuition for research-related seminars and conferences (excluding associated travel and related expenses, such as meals and entertainment), (6) software that provides analyses of the performance of securities portfolios (unless the software is used for marketing purposes) and (7) corporate governance research and rating services (if such reports and ratings are used to make investment decisions). Some proxy voting services incorporate corporate governance services in their overall product, but only the portion of proxy voting services that managers use to make investment decisions (as opposed to voting decisions) is considered “research”.

The Release clarifies that a portion of the expense of OMS and trade analytical software that provide permissible “research” is also permitted under the Safe Harbor. See “Mixed-Use Products and Services” below.

***Changes to Items Not Considered “Research”.*** The Release lists some items now explicitly outside of the Safe Harbor, including inherently tangible items products and services (such as telephone lines and office furniture) and other operational overhead expenses,<sup>2</sup> computer hardware (whether or not dedicated to delivery of particular research products) and the peripherals and delivery mechanisms associated with computer hardware or associated with the oral delivery of research (such as telecommunication lines). In a reversal from the SEC’s proposed interpretation last year, the Release states that mass-marketed publications are also excluded from the Safe Harbor. Mass-marketed publications are low-cost publications that are intended for and marketed to a broad, public audience, rather than intended to serve the specialized interests of a small readership.

**“Brokerage”.** The Release also updates the definition of “brokerage” products and services to mean those products and services that the manager uses from the point at which the manager communicates with a broker to execute an order through the point at which the funds or

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<sup>2</sup> The Release lists a number of such expenses, including expenses for travel, entertainment and meals associated with attending seminars, and travel and related expenses associated with arranging trips to meet corporate executives, analysts or other individuals who may provide eligible research, office equipment, office furniture and business supplies, salaries (including research staff), rent, accounting fees and software, website design, e-mail software, internet service, legal expenses, personnel management, marketing, utilities, membership dues, professional licensing fees and software to assist with administrative functions such as managing back-office functions, operating systems, word processing and equipment maintenance and repair services.

securities are delivered or credited to the client's account. Communication services related to execution, clearing and settlement, such as dedicated lines between the broker and a manager or the manager's OMS, and message services used to transmit orders, are eligible for the Safe Harbor. Trading software used to route orders to market centers, software that provides algorithmic trading strategies and software that transmits orders to direct market access systems are also eligible brokerage. OMS that include such trading software or provide connectivity to such software may also be permitted "brokerage".

***Changes to Items Not Considered "Brokerage"***. The Release lists specific types of items that are not permitted "brokerage" under the Safe Harbor, including (1) software used for recordkeeping or administrative purposes, including software used to manage portfolios and quantitative analytical software used to test "what if" scenarios (including such functionality provided by OMS and trade analytic software), (2) hardware, such as telephones and computer terminals, (3) products or services that a manager uses to meet a client's specific investment parameters or for internal compliance, including analysis of best execution, portfolio turnover rate or performance of similarly-managed accounts, creation of trade parameters and portfolio stress-testing, and (4) capital introduction services, margin services, and error correction trades or related services related to trade error correction. The Release also states that trade financing, such as stock lending fees, and long-term custody costs are excluded from "brokerage" because clients are responsible for payment of such items themselves, and thus the Safe Harbor is not implicated.

**Mixed-Use Products and Services**. Managers that use client commissions to pay for products and services that are only partly used for permissible "brokerage" and "research" must reasonably allocate the expense of those items between the eligible and ineligible uses and keep adequate books and records concerning those allocations. The Release provides examples of the factors on which a manager may base its allocation decision, such as the amount of time a product or service is used for eligible and ineligible purposes, an objective measure of the usefulness of the eligible and ineligible uses, and the extent to which the product or service is redundant with other products or services that the firm uses for the same purpose. The Release states that managers should disclose to the client the conflict of interest inherent in its allocation determination.

Common mixed-use items include OMS, trade analysis and portfolio performance software and proxy voting services. Managers that want to use soft dollars to pay for OMS and trade analysis software should now review and revise (if necessary) their written analysis about how they allocate the various functions available in their OMS and trade analysis software and systems, and determine the extent to which those functions are used for "research" and "brokerage" under the Safe Harbor. Pursuant to the Release, only the portion of a proxy voting service that managers use to make investment decisions is within the Safe Harbor. For example, some proxy voting services include corporate governance reports and ratings. Thus, the research provided by proxy voting services that is used to decide how to vote proxies and the service of handling the mechanical aspects of voting, such as casting, counting, recording and reporting votes, are not permitted "research" within the Safe Harbor.

**Lawful and Appropriate Assistance.** The Release reiterates previous SEC interpretations that the research or brokerage expense must provide lawful and appropriate assistance to the manager in the performance of its investment decision-making responsibilities. For example, the use of a “research” product such as portfolio performance analytics for marketing purposes would be outside the Safe Harbor.

**Good Faith Determination of Reasonableness.** The Release also reiterates previous SEC interpretations that the investment manager must make a good faith determination that the commission paid is reasonable in relation to the goods and services provided by the broker. For example, if a research product or service has simply been copied or aggregated, a manager should analyze whether the additional commissions paid for a particular item are warranted. In addition, a manager should not use commissions for research that is barely useful, if the commissions are intended to compensate the broker for another product or service that does not meet the Safe Harbor. The Release suggests that managers should consider the unbundled price (when that price is available) that a broker charges for research when making its good faith determination.

**Third Party Research and Other Commission-Sharing Arrangements.** The Safe Harbor is only available to a manager that pays a broker for “effecting” a securities transaction if the commission charged by that broker is reasonable in relation to the value of the services “provided by” such broker. Thus, a manager that enters into any of these arrangements with a broker should ascertain that such broker actually “effects” the trade and “provides” the services.

A manager may execute trades with one broker and use a portion of the commissions generated to obtain research and other services from another source. A manager also may send trades to an introducing broker with the understanding that another broker will execute, clear and settle the transactions. Variations of these arrangements are sometimes used. To give managers greater flexibility to obtain both best execution and research, the Release relaxes some of the SEC’s prior guidance regarding the level of involvement an introducing broker must have in a securities trade to be deemed to “effect” that transaction. Pursuant to the Release, a broker “effects” a transaction if it executes, clears or settles a trade, or if the broker meets at least one of the following four criteria: (1) the broker is financially responsible to the clearing broker for all customer trades until the clearing broker receives payment or securities; (2) the broker keeps required records relating to its customer trades; (3) the broker monitors and responds to customer comments concerning the trading process; and (4) the broker generally monitors trades and settlements. In case of doubt about whether a broker is meeting those requirements, we recommend that the manager’s contract with that broker require the broker to comply with this section of the Release.

The Release reiterates previous SEC interpretations that a broker “provides” research and brokerage services within the Safe Harbor if the broker is legally obligated to pay for those goods or services. The Release provides a new way for a broker to “provide” research and brokerage under the Safe Harbor when it is not legally obligated to pay for those goods and services. Such a broker must (1) pay the research preparer directly, (2) review the descriptions of the services to be paid for red flags that indicate that the services are not within the Safe Harbor and agree with the manager only to pay for items that reasonably are within the Safe

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Harbor and (3) develop and maintain procedures for properly documenting and paying for research. Many introducing brokers comply with the previous SEC interpretations by entering into direct contracts with research firms that obligate the brokers to pay those firms for the services provided to the advisers. You should consult with us if you are unclear or do not have documentation about whether your current soft dollar arrangements comply with previous SEC interpretations or whether a broker's proposed arrangement designed to take advantage of the new alternative complies with the Release.

**Effective Date of the Release.** The guidance in the Release is effective immediately, but managers may continue to rely on the SEC's prior interpretations until January 24, 2007. The SEC has requested further public comment by September 7, 2006, regarding its guidance on commission-sharing arrangements and may issue subsequent guidance based on those comments.

**Potential Further Soft Dollar Regulation.** The SEC staff has stated that it hopes to propose rules for disclosure and recordkeeping of soft dollar arrangements later this year. Based on prior SEC staff comments, such rules might require disclosure to investors of the total commissions and commission rates paid to brokers and soft dollar expenditures.

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This letter only summarizes the highlights of the Release. If you have any questions regarding the Release, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Joan Grant, Lyn Roberts, John Hunt, Anthony Caldwell, Jim Frolik, Christina Mickelson or Courtney Noble.

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