

Client
Advisory

**SIA Soft Dollar and Institutional
Brokerage Conference**

July 2004

The Securities Industry Association recently held its Soft Dollar & Institutional Brokerage Conference in New York City. Some of the more notable speakers included U.S. Senator John E. Sununu and SEC Commissioner Paul S. Atkins. The conference, among other things, shed some light on how the politicians, regulators, media and industry participants currently view the state of soft dollar arrangements.

What became evident throughout the conference was the fact that the general public and the majority of politicians do not fully understand the concept of soft dollars and the issues involved. Much of the recent criticism regarding soft dollars stems from the fact that they are associated with mutual funds, an area of extreme regulatory scrutiny over the past two years. Another driving force behind such criticism is that the term “soft dollars” carries a negative connotation (similar to use of the term “junk bonds” to describe high-yield debt instruments during the late 1980s). In addition, the terms “soft money” and “soft dollars” have also been commonly used in Washington to describe certain, now illegal, campaign finance practices. In this regard, there were many suggestions for using alternative terms, including “independent research commissions,” “research commissions” and “bonded commissions.”

The SEC has also taken steps to examine the current state of soft dollar regulations. For instance, Larry E. Bergmann, Senior Associate Director of the SEC’s Division of Market Regulation, discussed the recent creation of the SEC’s Soft Dollars Task Force. The Task Force’s mission is to gain a full understanding of all aspects of how soft dollars are used, as well as the pros and cons of various alternative reform approaches, including any possible unintended consequences of some suggested reforms. The Task Force has already met with a number of industry representatives and expects to have an initial report on its findings by the end of 2004.

Any legislation or regulations regarding soft dollars will most likely not be proposed until sometime in 2005, at the earliest. Furthermore, the various speakers and panelists suggested that is unlikely that soft dollar practices will be entirely banned. Rather, any legislation or regulations will likely focus on disclosure and transparency issues (*i.e.*, a requirement to itemize commission bills into execution and research components), and further clarifying, and perhaps narrowing, the definition of “research” under Section 28(e) to combat abusive practices. Finally, Senator Sununu made clear, and Commissioner Atkins and Senior Associate Director Bergmann agreed, that there should not be a distinction between proprietary research and third party research for purposes of soft dollar arrangements.

Investment Adviser Code of Ethics

The SEC recently adopted new rules under the Investment Advisers Act of 1940 which requires each registered investment advisory firm to adopt a written code of ethics applicable to its advisory personnel. Under the new rules, the code of ethics must require, at a minimum:

- Periodic reporting to the chief compliance officer (or other designee) of personal securities transactions and holdings by personnel (called “access persons”) who have access to nonpublic information regarding client transactions, including recommendations;
- That access persons receive prior written approval prior to personally participating in an IPO or private placement;
- That personnel promptly report violations of the code of ethics to the chief compliance officer; and
- That the adviser provide a copy of the code of ethics and any amendments to each supervised person, who must acknowledge receipt thereof in writing.

The new rules will also require advisers to retain for five years (two years in an easy accessible place) copies of their code of ethics, records of violations thereof and related corrective actions, and copies of the written acknowledgments of receipt. In addition, the code of ethics will be required to be described in Part II of Form ADV.

Although the new rules become effective on August 31, 2004, registered investment advisory firms have until January 7, 2005 to comply. It should also be noted that these requirements are separate and distinct from those recently approved which require registered investment advisory firms to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and to designate an individual (who is a supervised person) responsible for administering the policies and procedures adopted. *See* SEC Rule 206(4)-7. The compliance date for *these* requirements is October 5, 2004.

Please contact us should you require assistance in creating a code of ethics or updating your written procedures.

Business Continuity Plans

As a reminder, NYSE members and member organizations must comply with NYSE Rule 446 (“Business Continuity and Contingency Plans”) by August 5, 2004.

NYSE Rule 446, which was approved by the SEC on April 7, 2004, requires members and member organizations to establish and maintain business continuity and contingency plans (“BCPs”).¹ The new rule generally requires members and member organizations to establish and maintain BCPs relating to an emergency or significant business disruption. It also requires that a member’s or member organization’s BCP be reasonably designed to enable it to meet its existing obligations to customers, and address existing relationships with other broker-dealers and counter-parties. Moreover, Rule 446(c) provides that a BCP shall be tailored to the size and needs of a member or member organization and sets forth certain elements that a BCP must, at a minimum, address. Those elements are:

- Books and records back-up and recovery (hard copy and electronic);
- Identification of all mission critical systems and back-up for such systems;
- Financial and operational risk assessments;
- Alternate communications between customers and the firm;
- Alternate communications between the firm and its employees;
- Alternate physical location of employees;
- Critical business constituent, bank and counter-party impact;
- Regulatory reporting;
- Communications with regulators; and
- How the member or member organization will assure customers prompt access to their funds and securities in the event the member or member organization determines it is unable to continue its business.

Please contact us should you require assistance in creating a BCP or updating your written procedures.

Broker-Dealer Holding Companies May Elect Consolidated Supervision

The SEC recently adopted new rules establishing two separate voluntary regulatory programs for the SEC’s supervision broker-dealers and their affiliates on a consolidated basis.

¹ A similar rule applicable to NASD members (*see* NASD Rule 3510) was approved by the SEC on April 7, 2004. The compliance date for this rule is as follows: Clearing Firms – August 11, 2004; Introducing Firms – September 10, 2004.

One program establishes an alternative method of computing net capital charges for certain broker-dealers which are part of a holding company which manages risks on a group-wide basis if the holding company consents to such group-wide supervision. The holding company and its affiliates, if subject to SEC supervision, will be referred to as a “consolidated supervised entity” or “CSE.” Under this program, broker-dealers will be permitted to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk.

The other program will implement Section 17(i) of the Exchange Act, which created a new structure for the consolidated supervision of “investment bank holding companies,” or “IBHCs,” and their affiliates. Under the new rules, an IBHC that meets certain criteria may voluntarily register with the SEC as a “supervised investment bank holding company,” or “SIBHC.” If such an election is made, the SEC will monitor the financial condition, risk management and activities of the SIBHC and its affiliates on a group-wide basis. The new rules also establish an application process for an IBHC to become supervised as a SIBHC, as well as certain regulatory requirements for SIBHCs.

Both CSEs and SIBHCs will be required to comply with rules regarding their respective group-wide internal risk management control system, and will be required to periodically provide the SEC with consolidated computations of allowable capital and risk allowances (or other capital assessment) prepared in a form that is consistent with the Basel Standards.

These new rules become effective on August 20, 2004.

NYSE to Abolish Grandfather Exemption to Continuing Education Requirements

The NYSE recently adopted an amendment to its continuing education rules (*i.e.*, Rule 345) which would remove the grandfather clause and other exemptions from its Regulatory Element course material. If approved by the SEC, the amendment would effectively require the same level of training for all registered persons.

The NASD is currently considering similar action.

Expungement of Customer Dispute Information From CRD

NASD Rule 2130, adopted earlier this year, is currently effective. This rule establishes procedures for members and associated persons to obtain expungement of customer dispute information, such as customer complaints, arbitration claims and court filings made by customers, and the arbitration awards or court judgments that may result from such claims or filings.

Members and associated persons seeking to expunge from CRD information arising from disputes with customers must obtain an order from a court directing such expungement or confirming an arbitration award containing expungement relief. Such expungement relief may only be granted if the panel finds that: (1) the claim, allegation or information is factually impossible or clearly erroneous; (2) the registered person was not involved in the alleged sales practice violation, forgery,

theft, misappropriation or conversion of funds; or (3) the claim, allegation or information is false. The award would state whether expungement is granted, and if so, on what basis.

If the parties settle the arbitration, they may jointly ask the arbitration panel for a stipulated award and request that the panel order expungement based on one or more of the standards in NASD Rule 2130. The arbitrators may, however, require the submission of documents or a brief evidentiary hearing to gather the information necessary to make its findings.

The next step is to obtain a court order. Members and associated persons seeking a court order to expunge must name the NASD as an additional party and serve the NASD with all appropriate documents unless the NASD waives that requirement. The NASD will waive the obligation to be named as a party if it determines that the expungement relief is based on one or more of the standards in the NASD Rule 2130.

Questions

We welcome your questions and comments. If you have any questions or would like more information about the contents of this Advisory, please call any of the following attorneys at Kelley Drye & Warren LLP:

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