INTERNAL AUDITORS DIVISION
An Affiliate of SIFMA

Internal Audit Guidelines
Soft Dollars

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I. INTRODUCTION TO SOFT DOLLARS

Scope of Internal Audit Guidelines

The internal Audit Guidelines for Soft Dollars is a tool designed to facilitate the internal auditors' determination and assessment of the potential risks inherent in soft dollar activities and the related controls which an organization may use to manage, monitor and evaluate those risks. Also included are possible worksteps that the Internal Auditor may perform to assess the effectiveness of controls and processes used in the monitoring of a firm's soft dollar business**.** These guidelines were designed to evaluate the risks associated with soft dollar arrangements from the perspective of both an investment manager, who would be providing soft dollars, and a broker-dealer, who would be providing the services in return for the soft dollars.

General Background

The Securities and Exchange Commission (the "SEC") has defined the term 'soft dollars' to mean the products and services (other than execution of securities transactions) that an investment manager receives in return for the manager's direction of client brokerage transactions (i.e., so-called order flow). Investment managers realized that their securities transaction order flow was, in effect, an asset that they could use to purchase research and brokerage services without having to pay for it directly. Theoretically, this enables access to research information to a much broader spectrum of investment managers, especially to those who might not otherwise be able to afford it. However, such arrangements contain inherent conflicts of interest that could be detrimental to the account holders of the manager. For example, the manager may decide to execute their securities transactions through a broker solely in return for research services without regard to the broker's best execution performance.

The soft dollar business came into existence after the deregulation of fixed commissions in 1975. Recognizing the inherent conflict of interest that exists with soft dollar arrangements, yet not wanting to eliminate the access to research information that it provides, in 1975 Congress enacted Section 28(e) of the Securities and Exchange Act of 1934. Section 28(e) provides a safe harbor for an investment manager who "solely by reason of his having caused the account to pay a member of an exchange, broker, or dealer an amount of commission for effecting a securities transaction in excess of the amount of commission another member of an exchange, broker, or dealer would have charged for effecting that transaction, if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided by such member, broker, or dealer…" In other words, an investment manager will not be deemed to be in breach of its fiduciary responsibility to obtain best execution for securities transactions if soft dollars are used and the manager complies with the requirements of Section 28(e).

The interpretation of what was permissible under Section 28 (e) was modified by a series of interpretive releases issued by the SEC. The intent of these releases was to provide guidance to participants in soft dollar arrangements. The effect of the releases was to narrow the types of products and services that qualify under the "safe harbor" provisions.

General Background (Cont'd)

Section 28(e)(3) defines what constitutes acceptable brokerage and research services as follows:

- The furnishing of advice, either directly or through writings about the "value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities purchasers or sellers of securities."
- The furnishing of "analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts."
- The effecting of securities transactions and the performance of functions incidental to executing transactions, such as clearance, settlement and custody.

In 1976 the SEC issued an interpretive release stating, among other things that the safe harbor provision did not apply to products and services that are readily available to the general public on a commercial basis.

In a 1986 release the SEC rescinded the 1976 release and concluded that, if the product or service satisfied the safe harbor definition of providing lawful and appropriate assistance to the money manager in its investment decision making, it could constitute acceptable research. The 1986 release also stated that client commissions could be used to acquire third party research. A new concept was introduced in the 1986 release, the so-called "mixed use" products and services. Mixed use refers to soft dollar services that contain elements of both eligible and non-eligible products and services. For example, management information services which integrate trading, execution, accounting, recordkeeping and other administrative services would be considered a mixed use service. When a product has a mixed use, the investment manager must make a reasonable allocation of the cost between eligible and non-eligible elements and the safe harbor provision would only apply to the eligible portion. Finally, the 1986 release concluded that, in the case of third party research, the broker is not providing such research when it is paying for an obligation incurred by the money manager. In other words the obligation to pay for the third party research must be the liability of the broker.

In 2001 the SEC issued another interpretive release that modified their definition of commissions for purposes of the safe harbor provision to encompass fees paid for riskless principal transactions in which both legs are executed at the same price and reported under the NASD's trade reporting rules.

General Background (Cont'd)

In October of 2005, the SEC published a proposed interpretive release that would further clarify acceptable soft dollar practices and replace Sections II and III of its 1986 release. In the proposed release the SEC reiterates its earlier criteria of what constitutes eligible brokerage and research. Under the SEC criteria:

- The products or services must fall within the specific eligibility requirements of Section 28(e).
- The products and services must provide "lawful and appropriate assistance" to the investment manager in carrying out its decision making responsibilities.
- The investment manager must make a good faith determination that the commissions paid are reasonable in relation to the value of the products and services received.

Under the proposed release eligible research services include advice, analyses and reports that have "intellectual and informational content." Such things as market, financial and economic analyses, among other things, would presumably meet the definition while products with inherently tangible or physical attributes would not. For example, computer hardware and accessories, while they might assist in the delivery of research, would not be eligible because they do not reflect substantive content.

The proposed release also identifies those types of brokerage services that would be eligible under the safe harbor provisions. In general, brokerage services are defined as those activities required to effect securities transactions and functions incidental thereto. The proposal states that brokerage begins when the investment manager submits an order to the broker-dealer for execution and ends when funds or securities are delivered or credited to the advised account or the account holder's agent. Some examples of services that would be considered eligible under this standard include:

- Post trade matching
- The exchange of messages among broker-dealers, custodians and institutions
- Electronic communication of allocation instructions
- The routing of settlement instructions to custodian banks and broker dealers' clearing agents

Order management systems used by money managers would be excluded from eligible brokerage services as well as surveillance and compliance systems and error correction services.

In July 2006, the SEC made effective this release but has allowed market participants until January of 2007 to be in compliance with its provisions.

Managing Soft Dollars

The management of soft dollar arrangements will vary greatly from organization to organization depending on the extent of soft dollar activities, the size of the organization, and whether the entity is an investment manager receiving research and brokerage services in exchange for soft dollar commissions or broker-dealer providing the research and services.

A lack of understanding of the safe harbor requirements has been a repetitive theme throughout the history of soft dollar arrangements. One of the most important things that an organization can do is to ensure that everyone who is involved in soft dollar activities understands the requirements that must be adhered to. In that regard, a written policy should be in place that describes which activities are acceptable and which are not. In larger organizations an independent group, such as a soft dollar committee might be charged with the oversight responsibility for soft dollar business. In smaller organizations a knowledgeable senior official should be assigned the responsibility.

A process should be established for monitoring soft dollar practices and should be administered by a group that is independent from sales and trading functions. The system should provide for the maintenance of detailed records supporting all soft dollar transactions, periodic analysis of soft dollar activity and allocation of mixed-use products and services.

Investment adviser disclosure of soft dollar practices should be carefully considered to make sure that it is sufficient. Consideration should be given to, among other things, disclosure of the following:

- Specific products and services that have been acquired using soft dollars
- Whether and to what extent higher commissions were paid than those that would have been paid if soft dollar commissions had not been used
- Any non-research or mixed products received and the method of compensation used
- That management has made a good faith determination that the commissions paid were reasonable in light of the products and services received

Risks/Audit Objectives

Regulatory risk relates to the potential that soft dollar activities do not comply with the safe harbor provisions of Section 28(e), exposing the firm to regulatory sanctions.

> ***Audit objective:*** Ascertain that procedures and controls over soft dollar activity are sufficient to ensure compliance with Section 28(e).

Financial risk represents the risk that soft dollar commissions are being used with no commensurate product or service in return or that the products or services received are not commensurate with the value of the soft dollar commissions used (investment manager perspective). From the broker-dealer perspective, the amount of soft dollar commissions received is not commensurate with the value of the products or services supplied.

> ***Audit objective:*** Determine that there is an effective process in place to measure the amount of soft dollar commissions versus the value of the goods and services received.

Technology risk *is* present in any environment where substantial reliance is placed on systems for conducting business activities. While not specific to audits of soft dollar activities, the auditor might want to consider certain controls with respect to soft dollar systems in use. Ensuring that only authorized individuals can effect transactions, that adequate segregation of duties exists to prevent one individual from having end-to-end control of the process and that system integrity and availability is ensured is critical.

> ***Audit objective:*** Determine that systems are (1) properly safeguarded from unauthorized access, and; (2) protected from unintended disruption.

Audit Guidelines

The following guidelines are not an exhaustive set of procedures that the auditor needs to follow during all audits of soft dollar arrangements. To best evaluate soft dollar activities at a specific firm, judgment should be exercised when determining the procedures to be performed and the sequence of performing those procedures.

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II A. AUDIT GUIDELINES

This guideline is intended to provide members of the Securities Industry Association, Internal Auditors Division with information for the purpose of developing or improving internal audit programs for reviewing soft dollar activities. The information is designed to provide guidance to member firms in the preparation of procedures tailored to the specific needs of their particular environment. Internal auditors should always use professional judgment in determining appropriate worksteps to complete specific audit steps.

The footnote in the "Risks to be Managed" section of the following tables is a cross-reference to the "Soft Dollar Process Diagram" included on page 16. This reference is included for informational purposes and can be used to determine the potential areas of the soft dollar process that may be affected.

Regulatory Risk

Risks to be Managed	***Types of Controls to Manage or Eliminate Risks***	***Potential Audit Workstep***
Non-compliance with the safe harbor provisions of Section 28(e) may expose the organization to regulatory sanctions, legal action and reputation damage. Non-compliance could take the form of one of the following: • Products or services do not fall within the eligibility requirements of Section 28(e). • Products and services do not provide lawful and appropriate assistance in carrying out the investment decision making process.	1. Written soft dollar policies and procedures clearly set forth acceptable practices under soft dollar arrangements. Policy and procedures have been approved by: ♦ Legal and compliance ♦ Soft dollar committee ♦ Board of directors, where applicable 2. All soft dollar arrangements must be in writing, clearly setting forth duties and responsibilities of all parties. Contracts must be approved by: ♦ Legal department ♦ Soft dollar committee	1. Review the written policy and procedures over soft dollar arrangements and ascertain that they clearly set forth acceptable practices and responsibilities. Verify that they have been approved by: ♦ Legal and compliance ♦ Soft dollar committee ♦ Board of directors 2. Obtain a list of soft dollar arrangements and: ♦ Verify that there is a written agreement ♦ Ascertain that the agreement has been approved by the legal department and the soft dollar committee ♦ Review the agreements to determine that they are in compliance with the safe harbor provisions of Section 28(e)

Regulatory Risk

Risks to be Managed	***Types of Controls to Manage or Eliminate Risks***	***Potential Audit Workstep***
• Failure to make a good faith determination that the commissions paid are reasonable in relation to the value of the products and services received	3. Formulas are established for mixed use products to allocate the costs between eligible and non-eligible. Client brokerage is prohibited to be used for the non-eligible portion of mixed use products.	3. For all agreements that provide for mixed-use products: ♦ Determine that a formula has been established for reasonably allocating the costs between eligible and non-eligible products/services ♦ Verify that actual costs have been allocated in accordance with the established formula ♦ Ascertain that allocation formulas are maintained by someone independent from portfolio management
	4. Soft dollar activity is monitored regularly (e.g., monthly) through either an automated system or manually. ♦ The trade processing system flags all soft dollar trades. ♦ Soft dollar credits are accrued based on the value of research or services received. ♦ Research/services received are reviewed for compliance with the safe harbor provisions of Section 28 (e). ♦ The amount of order flow directed under soft dollar arrangements is monitored in relation to the value of the research/services received.	4. Review the process for monitoring soft dollar activity and verify that: ♦ Ensure that soft dollar trades are systematically flagged and reviewed. ♦ Soft dollar credits are accrued based upon the value of research/services provided ♦ The research/services received are reviewed for compliance with the safe harbor provisions of Section 28(e) ♦ The amount of order flow directed is monitored in relation to the value of research/services received ♦ Documentation is maintained of the research/services received from each provider and the amount of client commissions used.

Regulatory Risk

Risks to be Managed	*Types of Controls to Manage or Eliminate Risks*	*Potential Audit Workstep*
	♦ Documentation is maintained of the research/services received from each provider and the amount of commissions paid. ♦ The monitoring process is performed by a group that is independent from portfolio management.	♦ The monitoring process is performed by a group independent from portfolio management
	5. A periodic analysis (e.g., every six months) of soft dollar activity is performed by a group independent from portfolio management. ♦ The value of specific research/services received is assessed versus the amount of client brokerage directed. ♦ The research obtained is evaluated to determine that it provides assistance in the investment management decision-making process and that it benefits the clients whose brokerage is used to obtain the research. ♦ A determination is made that commissions paid have been negotiated to obtain best execution in light of research/services received.	5. Determine that a periodic analysis of soft dollar activity is performed. Obtain the latest analysis and ascertain that it: ♦ Measures the value of research/services received from each provider versus the amount of client brokerage directed. ♦ Includes an evaluation of the research obtained as to the investment decision making process. ♦ Makes a determination that the research received benefits the clients whose brokerage was used to obtain it. ♦ Verifies that commissions paid have been negotiated to obtain best execution after consideration of research/services received. ♦ Evaluates mixed use products to verify that client brokerage has not been used for non-eligible services. ♦ Assesses the continued appropriateness of the formulas used to allocate mixed use products.

Regulatory Risk

Risks to be Managed	Types of Controls to Manage or Eliminate Risks	Potential Audit Workstep
	♦ Arrangements providing mixed use products are evaluated to determine that client brokerage is not used for the non-eligible portion. ♦ Allocation of mixed used products is assessed to determine that the basis for the allocation continues to be appropriate. ♦ Results of the periodic analysis is reported to the soft dollar committee	♦ Is presented to the soft dollar committee.

Financial Risk

Risks to be Managed	*Types of Controls to Manage or Eliminate Risks*	*Potential Audit Workstep*
Ineffective use of order flow could result in the value of research or products received not being commensurate with the value of commissions paid (or vice versa for a broker-dealer): • Order flow is directed to a broker-dealer without appropriate consideration of relevant criteria such as the value of research or services received, speed of execution, capacity and price improvement • Soft dollar order flow is not monitored to ensure that agreed upon research or services is received	1. Soft dollar credits are accrued for research/services received. Order flow can only be directed against accumulated soft dollar credits. 2. Periodic reports of soft dollar credits are provided to the portfolio manager. 3. Directed order flow is monitored versus soft dollar credits to ensure that sufficient credits exist to justify the order flow directed. 4. An independent group periodically assesses the value of research/services received in relation to commissions dollars paid (see Regulatory Risk #5).	1. Verify that soft dollar credits are accrued based on the value of research/services provided and that order flow can only be directed against soft dollar credits accumulated. ♦ Test the accuracy of soft dollar credits accrued. ♦ Evaluate the reasonableness of the basis used for accruing soft dollar credits (i.e., valuation of research/services received). 2. Ascertain that periodic reports of soft dollar credits are made available to the portfolio manager. ♦ Verify the accuracy of the reports. 3. Evaluate and test the process for monitoring the use of soft dollar order flow. 4. Determine that an independent group (e.g., Best Execution Committee) periodically assesses the value of research/services received in relation to commission dollars paid (see Regulatory Risk #5) and other relevant criteria such as speed, capacity and price improvement.

Financial Risk

Risks to be Managed	*Types of Controls to Manage or Eliminate Risks*	*Potential Audit Workstep*
• An independent assessment is not performed of the value of research and services received in relation to commission dollars paid		
• Adequate reserves have not been established for debits accrued for soft dollar commissions	5. A periodic analysis (e.g., quarterly) of soft dollar debits is performed to ensure realizability of amounts accrued. ♦ Soft dollar debits are aged. ♦ A reserve is established for amounts deemed uncollectible.	5. Review the realizability of soft dollar debits. ♦ Verify that soft dollar debits are periodically reviewed for collectibility. ♦ Ascertain that the reserve for uncollectible debits is adequate based upon their age and the level of business being conducted.

Technology Risk

Risks to be Managed	*Types of Controls to Manage or Eliminate Risks*	*Potential Audit Workstep*
Technology risk can lead to unauthorized system access and inappropriate authority levels as well as to loss of system availability: • System access is not appropriately restricted to authorized personnel. • Authorized users have the authority to perform functions that are not in line with their duties and responsibilities. • System program changes are not sufficiently controlled. • Disaster recovery is not adequate to ensure continued system availability and capability.	1. A responsible individual (e.g., system administrator) with no portfolio management responsibility controls all system access. ♦ Access forms are utilized to add, delete or change an individual's access. ♦ Forms must be approved by business managers. 2. Authority levels for users are established by the system administrator commensurate with their duties and responsibilities (i.e., no incompatible duties). 3. System access and authority level reports are periodically produced and reviewed by appropriate business managers to ensure access remains appropriate. 4. Individual user ID's and passwords are required and must be changed frequently.	1. Determine that the system administrator has no other portfolio management responsibilities. ♦ For a sample of system users verify that approved access forms are on file. 2. Obtain system reports of user access and authority and: ♦ Determine that only appropriate personnel have system access. ♦ Ensure that user authority levels are commensurate with their roles and responsibilities. ♦ Reconcile access reports to payroll records. 3. Verify that system access reports are periodically produced and reviewed by appropriate business managers. ♦ Select a sample of former employees who had system access and ascertain that their access was removed on a timely basis. 4. Ensure that user ID's and passwords are required and must be changed frequently.

Technology Risk

Risks to be Managed	*Types of Controls to Manage or Eliminate Risks*	*Potential Audit Workstep*
	5. Daily reports of all unsuccessful log-on attempts are produced and reviewed by the system administrator.	5. Verify that the system limits log-on and input attempts. ♦ Verify that system exception reports of failed log on's are reviewed daily.
	6. Programmed controls automatically log system changes. ♦ System changes are only made through an established change control process.	6. Review logs of system changes and verify that changes are made through an established change control process.
	7. Business continuity/disaster recovery plans have been approved and tested.	7. Verify the existence and regular testing of a Business Contingency Plan. ♦ Evaluate the adequacy of the back up plan in case of system unavailability.

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II B. SEGREGATION OF DUTIES CHECKLIST

Introduction

Adequate segregation of duties reduces the likelihood that errors (intentional or unintentional) will not be prevented and will remain undetected. The basic idea underlying segregation of duties is that no one employee or group of employees should be in a position both to perpetrate and to conceal errors or irregularities in the normal course of their duties. Additionally, errors may occur due to inadequate supervision of employee activity. In general, the principal incompatible duties to be segregated are: authorization, custody of assets, and recording or reporting of transactions. In addition, the risk management function as well as other oversight functions (Controllers, Compliance, Legal, Credit) should be separated from the functions that are originating risk itself and the processing of a transaction.

A practical method for using this checklist is to list the names of individuals responsible for particular functions. Review the checklist for individuals whose names are listed more than once and then make a determination whether that represents a potential lack of segregation of duties. Also consider whether individuals are performing incompatible duties. Once an individual is identified as performing incompatible duties, all duties performed by that individual should be challenged as to whether the effectiveness of those duties is reduced or eliminated by the lack of segregation of duties identified. Larger organizations may find it sufficient to list only the department performing each of these duties or functional job titles, rather than the names of individuals. Those companies could then evaluate whether any departments were performing incompatible duties.

Keep in mind that not all instances where an individual performs more than one function represent a lack of segregation of duties. In addition, it is important to remember that there is a possibility of a lack of segregation of duties within the same category. Consequently, completion of this checklist is intended to highlight potentially conflicting duties, not to be the only method of identifying all such conflicting duties. The segregation of duties checklist is located on the following page.

SEGREGATION OF DUTIES CHECKLIST

Establishing Soft Dollar Agreements

Who develops risk management policy? ____________

Who approves risk management policy? ____________

Who monitors adherence to risk management policy? ____________

Who initiates soft dollar agreements? ____________

Who approves soft dollar agreements? ____________

Who monitors soft dollar agreements? ____________

Who establishes formulas for mixed used services? ____________

Daily Monitoring

Who accrues soft dollar credits? ____________

Who reviews soft dollar research/services for eligibility? ____________

Who authorizes use of client commissions? ____________

Who monitors use of client commissions? ____________

Periodic Analysis

Who performs periodic analysis of soft dollar activity? ____________

Who reviews/approves analysis of soft dollar activity? ____________

System Access and Authority

Who is responsible for granting system access? ____________

Who establishes user authority levels? ____________

Who approves system access and authority levels? ____________

Who reviews system access reports? ____________

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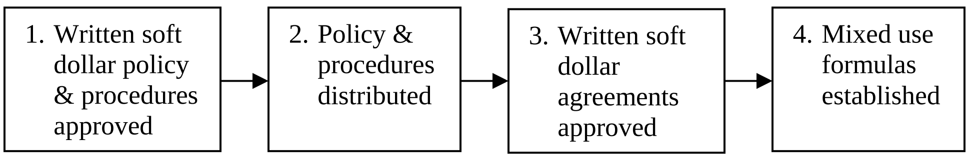
III. SOFT DOLLARS FLOWCHART

The following flowchart illustrates the typical Soft Dollar transaction cycle. Definitions for the individual process steps are included below. Such definitions are numbered in order to cross-reference with the appropriate process steps.

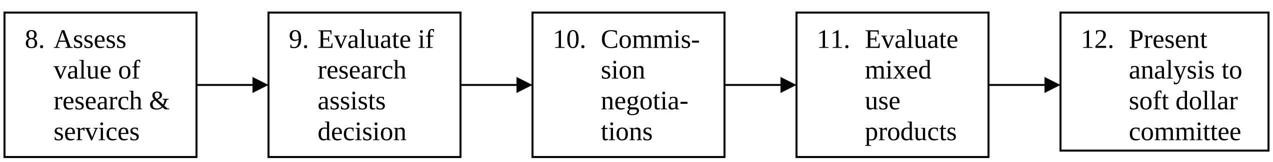
Soft Dollar Diagram Flowchart

Establishing Soft Dollar Agreements

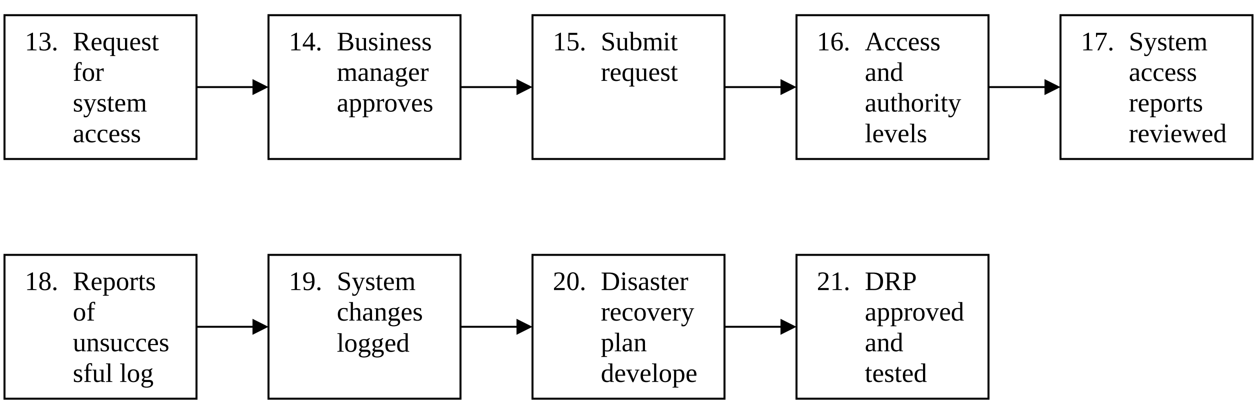


Daily Monitoring

Periodic Analysis



System Access



Definition of Process Steps

1. Written policies and procedures concerning soft dollar arrangements are prepared. They are approved by the soft dollar committee, senior management and, where applicable the board of directors.
2. The soft dollar policy and procedures are distributed to all employees who are involved in soft dollar activities.
3. Written soft dollar agreements are obtained from research/service providers. Agreements are approved by the appropriate approval authority (e.g., soft dollar committee, legal and compliance).
4. Formulas are developed for allocating cost between eligible and non-eligible products/services under mixed use agreements.
5. Soft dollar credits are accrued based upon the value of research and services received.
6. Research/services received are reviewed by a group independent from portfolio management to ensure that they qualify as eligible for soft dollar treatment under the safe harbor provisions of Section 28(e) of the 1934 Act.
7. The use of order flow used to pay for soft dollar research/services is monitored by a group independent from portfolio management.
8. A periodic assessment is made to determine that the value of research/services received is reasonable in relation to the amount of soft dollar commissions paid.
9. An independent group makes a determination that the research received assists portfolio management in its decision making process.
10. As part of the periodic analysis of soft dollar commission activity, an assessment is made that commissions are being properly negotiated.
11. The use of mixed products/services is evaluated to determine that costs are being properly allocated between eligible and non eligible services.
12. The periodic analysis is presented to the soft dollar committee.
13. Request for system access form is prepared for individuals requiring access.
14. Appropriate business manager approves access request form.
15. Access request form is submitted to the system administrator.
16. System access and authority level is established after determining that authority level is consistent with the individual's responsibilities.
17. Periodically reports detailing who has system access and the level of their access are sent to business managers for verification.
18. System generated reports showing who successfully accessed system and who unsuccessfully attempted to access the system are reviewed by the system administrator.
19. System changes are automatically logged via programmed controls.
20. Business continuity and disaster recovery plans have been established.
21. Business continuity and disaster recovery plans have been approved and tested.