

**MEMO# 22792**

August 12, 2008

# **SEC Proposes Guidance Regarding Duties and Responsibilities of Fund Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices; Conference Call August 18**

[22792]

August 12, 2008

TO: CHIEF COMPLIANCE OFFICER COMMITTEE No. 9-08  
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 26-08  
COMPLIANCE ADVISORY COMMITTEE No. 12-08  
EQUITY MARKETS ADVISORY COMMITTEE No. 36-08  
FIXED-INCOME ADVISORY COMMITTEE No. 22-08  
INTERNATIONAL COMMITTEE No. 20-08  
SEC RULES COMMITTEE No. 58-08 RE: SEC PROPOSES GUIDANCE REGARDING DUTIES AND RESPONSIBILITIES OF FUND BOARDS OF DIRECTORS WITH RESPECT TO INVESTMENT ADVISER PORTFOLIO TRADING PRACTICES; CONFERENCE CALL AUGUST 18

The Securities and Exchange Commission has proposed guidance for boards of directors of registered investment companies to assist them in fulfilling their fiduciary responsibilities with respect to overseeing the trading of portfolio securities. [\[1\]](#) The proposed guidance focuses on the role of the board in overseeing the best execution obligations of the investment adviser in connection with soft dollar arrangements. The Commission requested general and specific comments on the proposed guidance. The Commission also solicited comments on whether to propose new disclosure requirements for investment advisers addressing the use of client commission arrangements to fund shareholders and other investment advisory clients. The proposed guidance is summarized below.

Comments on the proposed guidance are due by October 1, 2008. We will hold a

conference call on Monday, August 18 at 3:00 EDT to discuss the proposed guidance. The dial-in number is 800-475-0212 and the passcode is 56166. If you plan to participate on the call, please r.s.v.p. to Maureen Maher at [mmaher@ici.org](mailto:mmaher@ici.org) or 202/326-5823. If you are unable to participate on the call, you may provide your comments to Mara Shreck at [mshreck@ici.org](mailto:mshreck@ici.org) or 202/326-5923, or Ari Burstein at [aburstei@ici.org](mailto:aburstei@ici.org) or 202/371-5408.

## **Introduction and Background**

The Proposing Release begins by explaining the importance of board oversight of the conflicts of interest faced by investment advisers with funds as clients. It explains that the Commission has received requests from fund directors for guidance on their responsibilities to oversee the adviser's satisfaction of its best execution obligations. In response, the Commission is proposing guidance as to information a board should request from the fund's adviser to enable the board to determine that the adviser is fulfilling its fiduciary obligations to the fund and using the fund's assets in the best interest of the fund. The guidance is also intended to assist the board in directing the adviser as to how fund assets should be used. The Proposing Release states that the proposed guidance would not impose any new or additional requirements, but rather is intended to assist fund directors in approaching and fulfilling their responsibilities. It makes clear that the SEC, in developing its guidance, took into account the wide variety of funds and advisers in terms of size, asset classes, complexity, and operations, and also considered the rapidly evolving market conditions and trading practices. It then briefly summarizes the law regarding the fiduciary responsibilities of investment company directors, including the state law duties of loyalty and care, as well as certain obligations imposed by the Investment Company Act.

## **Board Oversight of Investment Adviser Trading Practices**

The Proposing Release next describes areas in which conflicts of interest may arise with respect to a fund's trading activities. It states that a fund's board, in providing its consent to the adviser's management of these conflicts, must be sufficiently familiar with the adviser's trading practices to satisfy itself that the adviser is fulfilling its fiduciary obligations and is acting in the best interest of the fund. It then provides guidance on the types of information a fund board should seek in order to conduct such evaluations.

## **Board Oversight of an Investment Adviser's Duty to Seek Best Execution and Consideration of Transaction Costs**

The Proposing Release reiterates the investment adviser's duty to seek best execution of securities transactions it conducts on a fund's behalf. It states that fund directors should seek relevant data from the fund's adviser to help them evaluate the adviser's procedures regarding its best execution obligations, and provides certain examples of such data. It also provides a list of related matters that fund boards may also discuss with the adviser with respect to best execution as well as relevant data from the fund's investment adviser to assist them in evaluating the adviser's procedures regarding its best execution obligations.

The Release states that this data should typically include, but not be limited to: (i) the

identification of broker-dealers to which the adviser has allocated fund trading and brokerage; (ii) the commission rates or spreads paid; (iii) the total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period; and (iv) the fund's portfolio turnover rates.

The Release further states that the matters fund boards should discuss with the adviser may include, among other things:

- The process for making trading decisions and the factors involved in the selection of execution venues and the selection of broker-dealers;
- The means by which the investment adviser determines best execution and evaluates execution quality as well as how best execution is affected by the use of alternative trading systems;
- Who negotiates commission rates, how that negotiation is carried out, whether the amount of commissions agreed to depends on comparative data with respect to commission rates, and generally how transactions costs are measured;
- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser's activities, including the trading intermediary selection process;
- The process for trading fixed-income securities and determining the costs of fixed income transactions; and
- If there are international trading activities, how these trades are conducted and monitored.

The Proposing Release requests comment on how changes in the brokerage industry should affect a fund board's oversight of an adviser's trading practices, and how boards should approach their obligations.

### **Board Oversight of an Investment Adviser's Use of Fund Brokerage Commissions**

The Proposing Release next describes a number of ways in which an investment adviser may use a portion of fund brokerage commissions to benefit the fund beyond execution of the securities transaction. The Proposing Release requests comment on its discussion of the various uses of fund brokerage. It then describes a number of ways that conflicts of interest may arise when investment advisers use soft dollar arrangements including, for example:

- The use of fund brokerage commission to buy research may relieve an adviser of having to produce the research itself or having to pay for the research with "hard dollars" from its own resources;
- The availability of soft dollar benefits that an adviser may receive from fund brokerage commissions creates an incentive for an adviser to use broker-dealers on the basis of their research services provided to the adviser rather than the quality of execution provided in connection with fund transactions;
- The use of soft dollars may disguise an adviser's true costs and enable an adviser to charge advisory fees that do not fully reflect the costs for providing the portfolio management services; and
- The use of fund brokerage commissions to obtain research and other services may cause an adviser to avoid other uses of fund brokerage commissions that may be in the fund's best interest, such as establishing a commission recapture program or fund expense reimbursement arrangement to offset expenses that are paid for with fund

assets.

The Proposing Release states that, in evaluating an adviser's use of brokerage commissions in light of these conflicts, a fund board may determine that such use is in the best interests of the fund.

### **Section 28(e) under the Securities Exchange Act of 1934**

The Proposing Release briefly reviews its 2006 guidance to investment advisers on the scope of the safe harbor provided under Section 28(e) of the Securities Exchange Act of 1934. [2] It states that a fund board should request that the fund adviser inform directors of the policies and procedures used to ensure that the types of brokerage and research services obtained with fund brokerage commissions fall within the safe harbor, and that the adviser has not engaged in excessive trading in light of the fund's investment objectives. It further reaffirms the adviser's essential obligation under Section 28(e) to make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer, and states that an adviser should demonstrate to the board that it has met this burden.

The Proposing Release requests comment on this proposed guidance, as well as examples of effective practices employed by boards when evaluating whether an adviser has made the requisite good faith determination.

#### **An Investment Adviser's General Fiduciary Obligations to Clients that are Funds When Using Soft Dollars**

The Proposing Release next explains that, even when a fund adviser satisfies the requirements for using client commissions to pay for brokerage and research services under the Section 28(e) safe harbor, a fund's directors should still evaluate the adviser's use of brokerage commissions to determine whether the adviser is acting in the best interest of the fund. It explains that to do so, directors must understand the procedures that the adviser employs to address any potential conflicts of interest and ensure that fund commissions are being used appropriately. The Proposing Release suggests a number of matters about which the board should request information from the adviser including, among other matters:

- How the adviser determines the total amount of research to be obtained and how the research actually is obtained;
- The process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program (e.g., is a broker vote process or some other mechanism used);
- Whether any alternative trading venues that are used produce soft dollar credits;
- How soft dollar usage compares with the adviser's total commission budget; and
- How soft dollar products and services are allocated among the adviser's clients.

The Proposing Release also offers certain considerations for the board, such as whether it is appropriate for the adviser (1) to refrain from purchasing research services in connection with certain types of trades, depending on market conditions, and (2) to use fund brokerage commissions to receive brokerage and research services on some or all trades. It also recommends that the board inquire as to how the adviser's compliance policies and procedures with respect to soft dollars are determined and monitored.

The Proposing Release requests comment on the information boards should request and receive to facilitate their review of an adviser's use of soft dollars. It also requests comment on the proposed guidance in regard to how a board should approach its considerations.

### **Section 15(c) under the Investment Company Act**

The Proposing Release indicates that a fund board's review of the adviser's compensation under Section 15(c) of the Investment Company Act should incorporate consideration of soft dollar benefits the adviser receives from fund brokerage. To assist boards in carrying out this responsibility, the Proposing Release recommends that boards request certain types of information regarding the adviser's use of fund brokerage, including soft dollar arrangements. It requests comment on the information that boards should request and advisers should provide in connection with the board's review of the advisory contract under Section 15(c).

### **Disclosure to Other Advisory Clients and Fund Investors**

While acknowledging that the proposed guidance is designed to provide fund directors with information that will help them fulfill their oversight obligations with respect to the adviser's trading practices, the Proposing Release solicits comment on whether the SEC should propose additional disclosure requirements for advisers addressing the use of client commission arrangements to fund shareholders and other investment advisory clients. Specifically, the Proposing Release requests comment on whether:

- Further disclosure to fund investors of the information the Proposing Release suggests fund boards should consider would be helpful;
- Any specific disclosure should be mandated to better assist investors in making informed investment decisions; and
- The public dissemination of particular information regarding a fund adviser's portfolio trading practices would have an adverse impact on fund adviser's relationships with the broker-dealers that execute fund portfolio transactions.

The Proposing Release also seeks comment on whether the Commission should again consider proposing to require investment advisers to provide their clients with customized information about how their individual brokerage is being used. In relation to that issue, it asks the following additional questions:

- What types of information would be useful and in what detail?
- Should the information provided be different for institutional and non-institutional clients?
- Do institutional clients already require their advisers to provide information to them about soft dollars on a regular basis, and if so, what kind of information do they receive?
- What are the cost implications of requiring individual client reports?

**endnotes**

[1] See Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, SEC Release Nos. 34-58264, IC-28345, IA-2763 (July 30, 2008) (“Proposing Release”), available at <http://www.sec.gov/rules/proposed/2008/34-58264.pdf>.

[2] See Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934, SEC Release No. 34-54165 (July 18, 2006), available at <http://www.sec.gov/rules/interp/2006/34-54165.pdf>.

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