The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

October 1, 2008

ICI Comments to SEC Guidance with Respect to Investment Adviser Portfolio Trading Practices

October 1, 2008

Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Commission Guidance Regarding Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices (File No. S7-22-08)

Dear Ms. Harmon:

The Investment Company Institute[1] supports the goal of the Commission's proposed guidance—to provide assistance to fund boards of directors regarding their duties with respect to investment adviser portfolio trading practices.[2] We are pleased that the Proposed Guidance states that it is not intended to impose any new or additional requirements in this area and recognizes that there cannot be a "one size fits all" approach to a board's oversight of these practices.

While we support the Commission's objective to improve communications between fund boards and advisers on these issues, we have three concerns with respect to the Proposed Guidance. First, despite the Commission's statement that it did not seek to impose new or additional requirements in this area as currently drafted, certain aspects of the Proposed Guidance could be interpreted to impose additional responsibilities on fund boards, some of which go beyond boards' traditional oversight role. Second, certain language in the Proposed Guidance, and the overall tone of the Guidance itself, may create an impression that certain portfolio trading practices, particularly soft dollar practices, are per se unsuitable for funds, and that fund boards should therefore prohibit such practices. Finally, the Proposed Guidance appears to articulate a new standard for compliance with Section 28(e) of the Securities Exchange Act of 1934, at least with respect to registered investment companies.These aspects of the Proposed Guidance may compel some fund boards to reject longstanding portfolio trading practices out of hand, without due consideration of the benefits that these practices bring to the funds they oversee. They also represent a

troubling departure from the Commission's historic recognition of the appropriateness of these practices.

Our specific comments are provided below.

I. The Proposed Guidance May be Interpreted to Impose Additional Responsibilities on Fund Boards of Directors

The Proposed Guidance states that it "would not impose any new or additional requirements" and is intended solely to "assist fund directors in approaching and fulfilling their responsibilities of overseeing and monitoring" a fund adviser.3 While we support this approach, the overall tone of the Proposed Guidance and the "laundry list" of issues that a fund board is recommended to examine suggest a significant level of involvement that goes beyond the ordinary oversight role of fund boards.

For example, with respect to portfolio transaction costs, the Proposed Guidance states that "it is imperative that … directors both understand and scrutinize the payment of transaction costs by the fund," and that directors should "demand… all information needed by the fund's board to complete this review process" (emphases added).4 The Proposed Guidance further states that fund directors "should" review an enumerated list of relevant data and that, based on this and the proposed list of suggested information, should determine whether an adviser's trading practices are being conducted in the best interest of the fund and its shareholders. These directives appear to prescribe, rather than suggest for consideration, a specific list of tasks for directors and are more consistent with board micro-management than with traditional oversight. 5

Similarly, the Proposed Guidance overstates directors' responsibilities with respect to evaluating the use of fund brokerage commissions and soft dollars. For example, the Proposed Guidance advises boards to consider whether "the funds' brokerage commissions could be used differently so as to provide greater benefits to the fund" and, if so, to "direct the adviser accordingly."6 This would include consideration of, among other things, whether the adviser should "refrain from purchasing research services in connection with certain types of trades" or "use fund brokerage commissions to receive brokerage and research services on some or all trades."7 Read literally, the Proposed Guidance could be interpreted to require a board to consider the adviser's justification for each individual use of client commissions and to direct an adviser in its use of commissions in certain instances. Such responsibilities would necessitate an inappropriate level of involvement by the board in the day-to-day operations of the fund.

We also are concerned with the overall "checklist" approach of the Proposed Guidance. The Proposed Guidance includes several lists of items that directors "should request" from advisers and requests comment on the information boards "should receive" with respect to soft dollar usage. 8These checklists, and the accompanying prescriptive language, stray from the Commission's intention to provide directors with information "to consider" in performing their duties. Even in the limited instances where the Proposed Guidance expressly acknowledges that the enumerated considerations are not meant to be prescriptive,9 we are concerned that such factors may become de facto required—by directors' counsel, the Commission's examination staff, and ultimately even private litigants. This is essentially what happened with respect to the nine suggested—but explicitly not required—factors the Commission offered to "provide helpful guidance to directors" in connection with consideration of Rule 12b-1 plans.10

For these reasons, we recommend that any final guidance reiterate throughout the

Commission's intention to provide "guidance for fund directors to consider in performing their responsibilities"[11] and clarify that a fund board's role is to oversee the adviser's responsibilities. The Commission also should make clear in its final guidance that the Proposed Guidance's lists are only suggested lists of data, information, factors, or discussion items for fund boards to consider in light of the specific circumstances of the funds they oversee and not mandatory "checklists."[12] Finally, the final guidance should clarify that the role of directors is to evaluate the adviser's policies and procedures, and to periodically review compliance with such policies and procedures, rather than to make specific findings about individual transactions.

II. The Language and Overall Tone of the Proposed Guidance May Imply the Prohibition of Certain Portfolio Trading Practices

Congress implicitly recognized the benefits of soft dollars in its adoption of Section 28(e), and the Commission has issued several releases affirming and interpreting the use of this safe harbor, including most recently in 2006.[13] The tone of the Proposed Guidance, by contrast, demonstrates a far more negative approach to the use of soft dollars. This approach is evidenced both in the implication that board consideration of soft dollar arrangements should be an onerous process, as discussed above, and by the Proposed Guidance's emphasis on the potential conflicts of interest presented. The Institute is concerned that the overall tone of the Proposed Guidance may create an impression that soft dollar practices are unsuitable for funds, and may influence directors to alter their approach to oversight in this area. We strongly urge the Commission to present a more balanced discussion of these issues in its final guidance.

We are also concerned about the manner in which the Proposed Guidance discusses potential conflicts of interest associated with advisers' use of fund assets in soft dollar programs. The Proposed Guidance provides a long list of possible conflicts, after which it blithely states that "[w]hen evaluating an adviser's use of fund brokerage commissions in light of these conflicts, a fund board may determine that such use is in the best interests of the fund."[14]It offers no suggestions, however, about how such a determination should be made, nor an acknowledgment that oversight of conflicts is already among the board's most important responsibilities,[15] and one that boards have successfully carried out for many years. Such an acknowledgment would, in our view, improve the tone of the Proposed Guidance.

III. The Proposed Guidance Appears to Articulate a New Standard for Compliance with Section 28(e)

The Proposed Guidance places undue emphasis on directors' obligations to undertake a fund-specific analysis of soft dollar arrangements.[16] Section 28(e) explicitly permits an adviser to consider the value of soft dollar benefits to all accounts for which it exercises investment discretion, and the 2006 Release detailed the elements an adviser must satisfy to rely on the safe harbor. None of these elements require a client-by-client or fund-by-fund analysis of transactions. In suggesting that fund directors must conduct such an analysis, the Commission appears to be imposing restrictions on the availability of the safe harbor for advisers to registered investment companies. The Commission may not retract Section 28(e) through guidance, which it seeks to do in the Proposed Guidance. Directors' fiduciary obligations to act in the best interests of the fund and its shareholders can and should be met not by scrutinizing individual transactions, but by considering whether, on the whole, the soft dollar services acquired by the adviser are in the best interests of the fund.

For similar reasons, we request that the Commission clarify certain of the conflicts listed in

the Proposed Guidance. In particular, we do not agree that the use of a fund's brokerage commissions to obtain research that benefits an adviser's other clients necessarily presents a conflict of interest, particularly if the research also benefits the fund. Purchasing research and brokerage services with fund brokerage commissions that may benefit another advisory client is in no way inappropriate. As long as a fund board has determined that the fund is benefiting from the soft dollar services acquired by the adviser, the fact that other clients, including other funds, may receive more benefits should not lead to the conclusion that "services are inappropriately benefiting another of the adviser's clients at the fund's expense" (emphasis added).17

IV. Disclosure to Other Advisory Clients and Fund Investors

The Commission requests comment on whether it should propose additional disclosure to fund investors of the information it is suggesting that fund boards should consider. While we support disclosure of useful and relevant information to fund investors, we do not believe that such additional disclosure is warranted at this time. The disclosure regarding brokerage practices, including the use of soft dollars, that currently is required in fund registration statements,18 combined with fund board oversight of portfolio trading, provide a sound and balanced regulatory approach. We also note that the Commission is currently examining the ways to improve disclosure to investors in revisions to Part II of Form ADV.19

The Institute appreciates the opportunity to comment on the Commission's Proposed Guidance. If you have any questions about our comments or would like any additional information, please contact me at (202) 326-5815, Ari Burstein at (202) 371-5408, or Mara Shreck at (202) 326-5923.

Sincerely,
/s/ Karrie McMillan
Karrie McMillan
General Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Andrew J. Donohue, Director
Thomas R. Smith, Senior Advisor to the Director
Karen Rossotto, Adviser to the Director
Division of Investment Management

ENDNOTES

1The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.11 trillion and serve almost 90 million shareholders.

2See Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, SEC Release Nos. 34-58624, IC-28345 (July 30, 2008), 73 Fed. Reg. 45646 (Aug.

6, 2008) (“Proposed Guidance”).

3Proposed Guidance at 6.

4Id. at 5.

5As the Proposed Guidance indicates, Congress clearly intended that fund boards occupy a solely supervisory role. See id. at n. 28 (quoting legislative history explaining that directors have “overall fiduciary duties… for the supervision of all of the affairs of the fund” (citations omitted)); id at n. 29 (quoting the U.S. Supreme Court, stating that Congress’ intention in the Investment Company Act was clear, “to place the unaffiliated directors in the role of ‘independent watchdogs’” (citations omitted)).

6Proposed Guidance at 32.

7 Id.

8 Id. at 29, 31.

9 For example, with respect to information boards should discuss with advisers to consider best execution, the Proposed Guidance states, “[w]e acknowledge that not all funds would require an evaluation of each of these factors by their boards. Different factors may be appropriate for different funds….” Proposed Guidance at 19.

10See Bearing of Distribution Expenses by Mutual Funds, SEC Release Nos. 33-6254, IC-11414 (Oct. 28, 1980), 45 Fed. Reg. 73898 (Nov. 7, 1980).

11Id. at 7 (emphasis added).

12See, e.g., Letter from Robert W. Uek, Chair, IDC Governing Council, Independent Directors Council, to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, dated September 30, 2008.

13See 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), 71 Fed. Reg. 41978 (July 24, 2006) (“2006 Guidance”).

14 Proposed Guidance at 25.

15 See, e.g., id. at 4-5 (“Fund directors play a pivotal role in overseeing conflicts of interest investment advisers face when they have funds as clients.”); id at 10 (“A fund board has the responsibility, among other duties, to monitor the conflicts of interest facing the fund’s investment adviser and determine how the conflicts should be managed…”).

16 For example, the Proposed Guidance suggests that directors should “scrutinize the payment of transaction costs by the fund,” id. at 5; and should evaluate whether “the funds’ brokerage commissions could be used differently so as to provide greater benefits to the fund,” id. at 32.

17Id. at 32.

18 See Item 16, Form N-1A and Item 22, Form N-2 under the 1940 Act.

19See Amendments to Form ADV, SEC Release Nos. IA-2711, 34-57419 (March 3, 2008), 73

Fed. Reg. 13958 (March 14, 2008), and Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated May 16, 2008.

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