SEC Proposes Guidelines for Directors Overseeing Mutual Fund Portfolio Trading

On July 31, 2008, the United States Securities and Exchange Commission (“SEC”) published proposed guidelines (“Guidelines”) for mutual fund directors overseeing the portfolio trading practices of an investment adviser to a mutual fund.¹ The Guidelines address the board of directors’ review of the best execution obligations of the mutual fund’s investment adviser and soft dollar arrangements. In the proposing release (“Release 58264” or the “Release”), the SEC also discussed how directors should consider brokerage and soft dollars in their annual “15(c) review” of investment advisory contracts. In addition, the SEC requested comments on whether to propose a new disclosure document for investment advisers addressing the use of client brokerage arrangements.

Purpose of the Guidelines

Release 58264 begins with a discussion about brokerage costs and the SEC’s concern for fund shareholders since brokerage can be a substantial cost for many funds. The Release then reviews conflicts of interest that may arise in brokerage practices and soft dollar arrangements. With respect to brokerage, a conflict of interest between the investment adviser and mutual fund may arise:

- when an adviser executes trades through an affiliate;
- when an adviser determines the allocation of trades among its clients;
- when an adviser trades securities between clients;
- when an adviser uses fund brokerage commissions to pay for research and brokerage services, which may give the adviser the incentive to disregard its best execution obligation; and
- when an adviser trades the fund’s securities in order to earn credits for fund brokerage commission services.

In the SEC’s view, soft dollar arrangements create the following conflicts of interest:

- the use of fund brokerage commissions 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 use of soft dollars may give an adviser an incentive to compromise its fiduciary obligations and to trade the fund’s portfolio in order to earn soft dollar credits;
- 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;
- an adviser may seek to use fund brokerage commissions to obtain research that benefits the adviser’s other clients, including clients that do not generate brokerage commissions (such as fixed-income funds), those that are not otherwise paying more than the lowest available commission rate in exchange for soft dollar products or services (i.e., “paying up” in commission costs), or those from which the adviser receives the greatest amount of compensation for its advisory services;

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; 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; and the conflict of interest that arises when an adviser makes an allocation determination with respect to “mixed-use” products (i.e., research products or services obtained using soft dollars that may serve functions that are not related to the investment decision-making process, such as accounting or marketing) between the research and non-research uses of the product as required to fulfill the requirements under Section 28(e) of the Securities Exchange Act of 1934 (“Section 28(e)”).

Because of the conflicts that arise in connection with fund brokerage and soft dollar arrangements, the SEC believes that mutual fund directors need guidance so that they “both understand and scrutinize the payment of transaction costs by the fund and determine that payment of transaction costs are in the best interests of the fund and the fund’s shareholders.” The SEC added that “[w]ithout sufficient oversight by the fund’s board, transaction costs might inappropriately include payment for services that benefit the fund’s adviser at the expense of the fund and which the board believes should be paid directly by the adviser rather than with fund assets.”

Before setting forth specific guidelines, the SEC in Release 58264 reviewed its past interpretive positions on brokerage and soft dollars and the directors’ general fiduciary duties. The SEC mentioned its recently issued interpretive release covering the scope of the safe harbor provided by Section 28(e) to advisers engaging in soft dollar arrangements (i.e., using client brokerage commissions to purchase brokerage and research services for their managed accounts). In its review of mutual fund directors’ duties of loyalty and care under state law, Release 58264 reminded directors that they need not act alone in carrying out their oversight of brokerage practices and other areas. Rather, a fund director may rely on “written and oral reports provided by management, auditors, fund counsel, the fund’s chief compliance officer ... and other experts and committees of the board when making decisions, so long as the director reasonably believes that the reports are reliable and competent with respect to the relevant matters.”

Guidelines

The SEC in Release 58264 issued guidance on the types of information a fund board should seek in order to evaluate whether the adviser to its fund has fulfilled its obligations to the fund with respect to best execution and soft dollar arrangements.

Best Execution

The SEC recommended that fund directors seek data from the fund’s investment adviser to assist them in evaluating the adviser’s procedures regarding its best execution obligations. Data should include: (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 executed

2 Id.
3 Id.
5 Release 58264, supra n.1.
that are allocated to each broker-dealer during a particular period; and (iv) the fund’s portfolio turnover rates. Release 58264 next listed a series of topics that fund boards should periodically discuss with the adviser. These topics are set forth in Appendix A.

The SEC also directed directors to remain up to date on evolving trading services and technologies. These include alternative trading systems, newer trading venues, such as “dark pools,” and the use of advanced mathematical models or algorithmic trading systems and crossing networks.

**Soft Dollars**

Release 58264 reiterates the board’s duty to approve a fund’s soft dollar policies and procedures. In deciding whether to approve these policies and procedures, directors should consider, and the investment adviser should explain, how the policies and procedures eliminate or otherwise mitigate the conflicts of interest that exist when an adviser enters into soft dollar arrangements on the fund’s behalf. In the SEC’s view, the board should not approve such procedures unless it has a thorough understanding of the adviser’s procedures governing the adviser’s use of fund brokerage commissions to obtain brokerage and research services. To assist the board in gathering this information, Release 58264 sets forth a list of questions that the board should ask the adviser about its soft dollar arrangements. These questions are set forth in Appendix B.

It is clear from Release 58264 that it is the SEC’s view that a fund board would be acting perilously if it were to rubber stamp an adviser’s soft dollar arrangements. The SEC wants the board to be proactive. In fact, the SEC stated it “believes that the fund’s brokerage commissions could be used differently so as to provide greater benefits to the fund; the board should direct the adviser accordingly.”

Furthermore, the board in the SEC’s view should consider such matters as:

- whether it is appropriate for the adviser to refrain from purchasing research services in connection with certain types of trades, depending on market conditions;
- whether it is appropriate for the adviser to use fund brokerage commissions to receive brokerage and research services on some or all trades;
- whether fund brokerage commissions should be used only in connection with a commission recapture or expense reimbursement program; and
- whether some combination of these alternatives may be in the best interest of the fund.

**Brokerage, Soft Dollars and Section 15(c)**

The SEC in Release 58264 linked the directors’ oversight and monitoring responsibilities with respect to fund brokerage and soft dollar programs to the fund directors’ statutory duty in Section 15(c) of the Investment Company Act of 1940 to review annually the adviser’s compensation. The SEC directs the

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6 Id.
7 Id.
8 Section 15(c) provides in relevant part that “it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company.”
fund board to incorporate into its 15(c) review of the adviser’s compensation the soft dollar benefits that the adviser receives from fund brokerage. To determine this addition to the advisers’ compensation, the board should consider information about how a fund’s brokerage commissions and the adviser’s use of soft dollar commissions are allocated. In particular, fund directors should consider whether the adviser properly accounts for use of fund brokerage commissions to purchase research that primarily or solely benefits another client of the adviser.

The SEC was not clear in Release 58264 whether it expects the directors to quantify the benefit of brokerage and soft dollar arrangements to the adviser in its 15(c) review. The release did, however, contain the following passage to the Gartenberg case:

To the extent an adviser receives benefits from the use of soft dollars that are of “sufficient substance,” these benefits should be disclosed and considered by the fund’s board of directors.9

In Gartenberg, the court stated that “estimates of . . . ‘fall-out’ and ‘float benefits’ which, while not precise, could be a factor of sufficient substance to give the Funds’ trustees a sound basis for negotiating a lower Manager’s fee.”10 At the very least, it appears that the board with the assistance of the adviser will have to estimate the benefit (and if possible the dollar amount of such benefit) of the fund’s brokerage and soft dollar arrangements to the adviser.

Form ADV and Potential New Adviser Disclosure Document

Even though it did not directly apply to the review of brokerage and soft dollar arrangements by mutual fund directors, the SEC in Release 58264 noted that investment advisers are required to disclose their practices in this area in their Form ADVs. The SEC referenced recently proposed amendments to Part 2 of Form ADV, which would require advisers to discuss the conflicts of interest inherent in an adviser’s soft dollar practices and to describe the products and services acquired with soft dollars with enough specificity to permit clients to evaluate the conflicts of interest involved.11 It asked for comments on whether it should expand the types of information advisers should disclose about brokerage and soft dollars in their Part 2 to include many of the items discussed in Release 58264.

Surprisingly, the SEC is contemplating an entirely new disclosure document for investment advisers. In Release 58264, it requests comment on whether it should “require investment advisers to provide their clients with customized information about how their individual brokerage is being used.”12 The SEC did not elaborate on this possible proposal; however, it is highly likely that it will receive comment letters from the industry opposing a new disclosure document.

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9 Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 932-3 (2d Cir. 1982).
10 Id.
12 Release 58264, supra. n.1.
Comment Period

Release 58264 asks for comments about specific items in the proposed Guidelines. The SEC also noted that it is interested in any other issues relating to fund board oversight of advisers' portfolio trading practices. Comments are due to the SEC by October 1, 2008.

If you have any questions regarding this alert, or the services we provide, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

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Appendix A

Brokerage Review Items

Mutual fund directors when reviewing the brokerage practices of the fund’s adviser should consider:

- 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;
- How the quality of “execution-only” trades – trades that do not include payment for any additional research or services beyond execution – is evaluated compared to that of other trades (for example, whether trades that are executed through channels that include an additional soft dollar component are reviewed in comparison with execution-only trades to discern any discrepancies in the quality of execution);
- How the performance of the adviser’s traders is evaluated, as well as the aggregate performance of the firm’s traders as a whole, how the performance of each broker-dealer the adviser uses for fund portfolio transactions is evaluated, and how problems or concerns that are identified with a trader or a broker-dealer are addressed;
- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser’s activities, including the trading intermediary selection process;
- To what extent and under what conditions the adviser conducts portfolio transactions with affiliates;
- The process for trading fixed-income securities and determining the costs of fixed income transactions;
- How the quality of trade execution is evaluated with respect to fixed-income and other instruments traded on a principal basis; and
- If there are international trading activities, how these trades are conducted and monitored.
- 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;
- How the quality of “execution-only” trades – trades that do not include payment for any additional research or services beyond execution – is evaluated compared to that of other trades (for example, whether trades that are executed through channels that include an additional soft dollar component are reviewed in comparison with execution-only trades to discern any discrepancies in the quality of execution);

- How the performance of the adviser’s traders is evaluated, as well as the aggregate performance of the firm’s traders as a whole, how the performance of each broker-dealer the adviser uses for fund portfolio transactions is evaluated, and how problems or concerns that are identified with a trader or a broker-dealer are addressed;

- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser’s activities, including the trading intermediary selection process;

- To what extent and under what conditions the adviser conducts portfolio transactions with affiliates;

- The process for trading fixed-income securities and determining the costs of fixed income transactions;

- How the quality of trade execution is evaluated with respect to fixed-income and other instruments traded on a principal basis; and

- If there are international trading activities, how these trades are conducted and monitored.
Appendix B

Soft Dollar Arrangement Review Questions

Mutual fund directors reviewing soft dollar arrangements involving the fund should seek answers to the following questions:

- How does the adviser determine the total amount of research to be obtained and how will the research actually be obtained? In particular:
  - How does the adviser determine the amount to be spent using hard versus soft dollars?
  - How does the adviser determine amounts to be spent on proprietary versus third-party research arrangements?
  - What types of research products and services will the adviser seek to obtain and how will this research be beneficial to the fund?

- How does the adviser determine amounts to be used in commission recapture programs and expense reimbursement programs?

- What is the process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program? Is a broker vote process or some other mechanism used?

- Do any alternative trading venues that are used produce soft dollar credits? If so, how much?

- How does the adviser determine that the use of soft dollars is within the Section 28(e) safe harbor? In particular:
  - Is the product or service obtained eligible brokerage or research, as defined under Section 28(e)?
  - Does the product or service provide lawful and appropriate assistance to the adviser in carrying out its investment decision-making responsibilities?
  - Is the amount of commissions paid reasonable (based upon a good faith determination) in light of the value of brokerage and research services provided by the broker-dealer?

- How does soft dollar usage compare to the adviser's total commission budget?

- How are soft dollar products and services allocated among the adviser’s clients? Are the commissions paid for certain trades in fund portfolio securities similar to commissions paid for transactions in similar securities, or of similar sizes, by the fund and the adviser’s other clients (including clients that are not funds)? Are other clients paying lower commissions that do not include a soft dollar component? If so, does the adviser adequately explain the discrepancy in commission rates and provide the board data sufficient to satisfy the board that the fund is not subsidizing the research needs of the adviser’s other client? To what extent are the products and services purchased through soft dollar arrangements used for the benefit of fixed-income or other funds that generally do not pay brokerage commissions?

- What is the process for assessing the value of the products or services purchased with soft dollars?
What is the process used to evaluate the portion of a mixed use product or service that can be paid for under Section 28(e)?

To what extent does the adviser use client commission arrangements?

What effect do these arrangements have on how the adviser selects a broker-dealer to complete a particular transaction? How does the adviser explain that the use of client commission arrangements benefits the fund?