Board Oversight of Investment Adviser Trading Practices and Use of Soft Dollars

SEC Issues Proposed Guidance Regarding Mutual Fund Board Oversight of Investment Adviser Trading of Portfolio Securities and Use of Soft Dollars

SUMMARY

On July 30, 2008, the Securities and Exchange Commission published for comment proposed guidance to mutual fund boards regarding their duties and responsibilities in overseeing the trading practices of a fund’s investment adviser, including those associated with the adviser’s use of soft dollars. The proposed guidance follows the interpretive guidance issued by the SEC in 2006, which clarified the scope of the safe harbor provided to investment advisers that use fund brokerage commissions to purchase brokerage and research services in reliance on Section 28(e) of the Securities Exchange Act of 1934.

According to the SEC, the proposed guidance does not impose new requirements on fund directors or investment advisers, but rather proposes a flexible framework for directors to work within when conducting their oversight of an adviser’s trading practices. Specifically, the proposed guidance sets forth the types of information a fund board should consider when determining whether a fund adviser is fulfilling its best execution obligations and otherwise using fund assets, including brokerage commissions, in the best interests of the fund.

There is a great deal of useful background information and a survey of relevant current SEC policy and positions in the proposing release. This memorandum emphasizes specific proposed guidance.

The SEC requests comments on a number of questions, including with respect to possible new disclosure requirements concerning the use of soft dollars. Comments on the proposed guidance are due on or before October 1, 2008.
OVERSIGHT OF INVESTMENT ADVISER TRADING PRACTICES

Under the Investment Company Act and state law, a fund board has the responsibility, among other duties, to oversee and monitor the fund’s operations, including conflicts of interest that arise when a fund adviser causes the fund to trade portfolio securities. In the proposing release,¹ the SEC emphasizes that fund directors should be sufficiently familiar with the adviser’s trading practices to satisfy themselves that the adviser is fulfilling its fiduciary obligations and is acting in the best interests of the fund. The proposed guidance outlines information a fund board should consider when evaluating a fund adviser’s trading practices with respect to two specific areas where an adviser may face conflicts of interest when trading the fund’s portfolio securities—the adviser’s obligation to seek best execution and to use fund assets, including brokerage commissions, in the best interests of the fund. Although not limited in scope, the release summarizes board considerations of the adviser’s use of “soft dollars.”

Best Execution Obligations

The proposed guidance provides that fund directors should seek relevant data from the adviser to assist them in evaluating the adviser’s procedures regarding its best execution obligations.² According to the SEC, these data should typically include:

- identification of broker-dealers used in fund trading and brokerage;
- commission rates or spreads paid;
- total brokerage commissions and value of securities that are allocated to each broker-dealer; and
- fund portfolio turnover rates.

The SEC states that fund boards may also discuss related matters with fund advisers, including, where applicable:

- procedures for making trading decisions and evaluating execution quality, including with respect to fixed-income and other instruments traded on a principal basis;
- factors involved in the selection of execution venues and broker-dealers;
- the means for determining best execution and costs of fixed income transactions;
- how best execution is affected by the use of alternative trading systems;


² In the proposing release, the SEC reiterates its view that “best execution” means the duty to “execute securities transactions for clients in such a manner that the client’s total cost or proceeds in each transaction is the most favorable under the circumstances.” See Proposing Release at Section IIIA.
• how commission rates are negotiated, transaction costs are measured, and trading performance is evaluated;
• how the adviser oversees and monitors sub-adviser activities, including the trading intermediary selection process;
• the adviser’s portfolio transactions with affiliates; and
• how international trading activities are conducted and monitored.

The SEC acknowledges in the release that different factors may be appropriate for different funds. The proposed guidance provides that once a fund board reviews the relevant information from the adviser, the board should determine whether the adviser’s trading practices are being conducted in the best interests of the fund and its shareholders. If these interests are not being best served, the board should direct the adviser accordingly. The SEC requests comment regarding how boards should approach their obligations to oversee and evaluate the fund adviser’s trading practices, and whether there is additional information boards should request from the adviser to assist them in their review.

Use of Soft Dollars
The SEC emphasizes that fund brokerage commissions are fund assets, and as a result, fund boards should pay “particular attention” to conflicts of interest inherent in soft dollar arrangements when evaluating an adviser’s trading practices. In the proposing release, the SEC notes a number of conflicts of interest the fund board should consider when evaluating an adviser’s use of fund brokerage commissions. Among those described are:

• 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 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 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 interests.
In the case of “mixed-use” products, an adviser has a conflict when making an allocation determination between the research and non-research uses of the product pursuant to Section 28(e) of the Exchange Act.

The SEC notes that when evaluating an adviser’s use of fund brokerage commissions in light of these conflicts, a fund board may determine that its adviser’s use of brokerage commissions is in the best interests of the fund.

**Section 28(e) Safe Harbor**

Section 28(e) of the Exchange Act provides a safe harbor that protects investment advisers from liability for breach of fiduciary duty solely on the basis that the adviser caused an account over which it exercises investment discretion to pay more than the lowest commission rate in order to receive brokerage and research services provided by a broker-dealer, if the adviser determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received. In 2006, the SEC issued an interpretive release that provided guidance to investment advisers on the scope of the Section 28(e) safe harbor when advisers use brokerage commissions to purchase brokerage and research services.

The SEC emphasizes that although a fund adviser’s use of soft dollars may satisfy the requirements for the Section 28(e) safe harbor, fund directors should still evaluate the adviser’s use of soft dollars in order to determine whether the adviser is using fund assets in the best interests of the fund. In the proposing release, the SEC provides a list of questions a fund board should consider asking the fund adviser in order to gain an understanding of the procedures the adviser uses to address conflicts involved in the use of soft dollars and whether commissions are being used appropriately. Among the questions are:

- How does the adviser determine the amount of research to be obtained, and how will the research be obtained?
- What is the process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program?
- 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?
- 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?

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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"? How do these arrangements affect the adviser’s choice of broker-dealers? How does the use of these arrangements benefit the fund?

If, after receiving the adviser’s response to the board’s questions, the board determines 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. In directing the adviser, the SEC believes that the board should consider whether:

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

Section 15(c) of the Investment Company Act

Section 15(c) of the Investment Company Act requires the independent directors of a fund board to review the fund’s investment advisory contract on an annual basis, and further requires such directors to request and evaluate, and the fund adviser to furnish, such information as may reasonably be necessary for the directors to make the evaluation. According to the SEC, the fund board’s review of the advisory contract pursuant to Section 15(c) includes a review of the adviser’s compensation, which should incorporate consideration of any soft dollar benefits the adviser receives from fund brokerage. In this regard, the SEC states that at a minimum, fund directors should require investment advisers to provide them with information regarding their brokerage policies, and how the fund’s brokerage commissions, including soft dollar commissions, were allocated. The SEC requests comment on the information that boards should request and that advisers should provide in connection with the review of advisory contracts under Section 15(c).

4 The SEC describes a “client commission arrangement” as an arrangement in which an investment adviser agrees with a broker-dealer effecting trades for the adviser’s client accounts that a portion of the commissions paid by the accounts will be credited to purchase research either from the executing broker or another broker, as directed by the adviser. Proposing Release at Section III(B).
Rule 38a-1 of the Investment Company Act

Rule 38a-1 under the Investment Company Act requires that the policies and procedures of a fund adviser ("38a-1 Procedures") be approved by the fund board based on the board’s findings that the policies and procedures are reasonably designed to prevent the adviser’s violation of the Federal securities laws. The SEC emphasizes that when an adviser seeks the fund board’s approval of the adviser’s compliance policies and procedures, fund directors should satisfy themselves that the adviser’s policies and procedures are reasonably designed, adequate, and being effectively implemented to prevent violations of the Federal securities laws. An adviser’s 38a-1 Procedures must address compliance by the adviser with its obligations to seek to obtain best execution, appropriately allocate fund transactions and commissions consistent with its fiduciary duties and address the conflicts of interest associated therewith.

Board Oversight in Light of Evolving Market Conditions

The SEC notes a number of recent changes in the brokerage industry (including the rapid development of newer trading venues, such as “dark pools,” and the increased use of alternative trading systems) that, in their view, affect a fund board’s oversight of the trading practices of the adviser. In this regard, the SEC emphasizes that fund boards need to remain current on evolving market conditions and trading practices. The SEC requests comment on how changes in the brokerage industry should affect a fund board’s oversight of the trading practices of the fund’s adviser, whether its discussion of the brokerage industry (as relevant to funds and their advisers) is accurate, and whether there are other considerations with respect to the brokerage industry the SEC should take into account.

DISCLOSURE TO OTHER ADVISORY CLIENTS AND FUND INVESTORS

Part II of Form ADV, the adviser’s brochure, must address the adviser’s soft dollar practices and the SEC staff has historically raised concerns about the adequacy of advisers’ disclosures on soft dollar practices generally. As a result, the SEC also requests comment on whether investment advisers should be subject to additional disclosure requirements concerning the use of client commission arrangements to fund investors and other advisory clients.

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