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A legal update from Dechert's Financial Services Group

SEC Issues Proposed Guidance to Fund Boards Relating to Best Execution and Soft Dollars

The Securities and Exchange Commission (the "SEC" or "Commission") recently issued a Release proposing guidance to mutual fund boards of directors regarding their duties in overseeing the trading practices of funds' investment advisers.[1] The Release focuses on the role of fund boards in evaluating whether funds' investment advisers are fulfilling their obligations to seek best execution in trading the funds' portfolio securities, and addresses how boards should assess the advisers' use of fund brokerage commissions to acquire products and services other than trade execution, such as investment research (referred to herein as "soft dollar" practices). The period for comments ends on October 1, 2008.

Summary

Under a safe harbor provided by Section 28(e) of the Securities Exchange Act of 1934 (the "Exchange Act"), investment advisers are permitted to receive soft dollar credits for certain research and brokerage services in exchange for placing portfolio trades with a broker-dealer if certain conditions are satisfied.[2] In addition to showing general concern about transaction costs incurred by funds due to portfolio transactions, the Commission has previously maintained and again notes in this Release that the soft dollar practices of investment advisers raise certain conflicts of interest.[3]

While the SEC's previous interpretive guidance in the 2006 Release was directed primarily to investment advisers, this Release is directed primarily to mutual fund boards of directors. The Commission states in the Release that a fund board should "both understand and scrutinize the payment of transaction costs by the fund and determine that payment of transaction costs is in the best interests of the fund and the fund's shareholders" in order to ensure that an investment adviser is fulfilling its fiduciary duty to the fund to seek best execution in the fund's portfolio transactions. To that end, the purpose of the Release is to "propos[e] guidance with respect to information a fund board should request that an investment

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1 SEC Release No. 34-58264, "*Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices*" (July 30, 2008) (the "Release").

2 *See* SEC Release No. 34-52635 ("*Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934*") (July 18, 2006) (the "2006 Release") for additional information regarding Section 28(e) and the Commission's interpretive understanding of its scope and provisions. *See also Dechert OnPoint* legal update issue 11 (August 2006) addressing the same subject.

3 *See* SEC Release No. IC-26313 ("*Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*") (December 18, 2003).

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adviser provide to enable fund directors 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"and "is intended to assist the board in directing the adviser as to how fund assets should be used." The Commission emphasizes that this Release is not intended to impose additional requirements on fund boards.

Legal Responsibilities of Fund Boards Generally

State laws, under which funds are created as corporations, trusts, or partnerships, impose fiduciary duties on a fund board, including a duty of care[4] and a duty of loyalty to the fund and its shareholders. Moreover, the Investment Company Act of 1940 (the "1940 Act") imposes additional obligations on a fund board, including fiduciary obligations.[5] The Release notes that because of the unique management structure of most funds (which themselves generally do not have employees, but instead are managed by external investment advisers), the 1940 Act requires that a board of directors oversee a fund's operations as an "independent watchdog" to protect fund shareholders, and this oversight role includes monitoring conflicts of interest between the adviser and the fund.

Board Oversight of Adviser Trading Practices

The Release states that as part of its obligation to monitor potential conflicts of interest between a fund and its investment adviser, a fund board must consider the adviser's trading practices as they relate to the fund's portfolio transactions.[6] While an adviser is also a fiduciary and owes a duty of best execution to the funds it manages,[7] the soft dollar products and services it may receive in exchange for assigning orders to broker-dealers creates an incentive to disregard this obligation.

Board Oversight of Best Execution

The Release reiterates the Commission's view that "best execution" involves more than commissions and spreads, and includes "'the full range and quality of a broker's services in placing brokerage. . . .' [which] might include, among other things, the value of research provided, execution capability, financial responsibility, and responsiveness to the adviser." The Release says that an adviser should seek to minimize overall transaction costs, both explicit and implicit,[8] incurred by the fund, but may also take into account the quality and utility of research provided by the broker-dealer. In this regard, the Release adds that a fund board should consider an adviser's use of alternative trading systems and platforms, which may result in lower transaction costs.

The Release goes on to explain that advisers use a number of methods in selecting broker-dealers to execute fund transactions, and therefore an adviser

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4 The Release states that this incorporates a duty to be informed of all material information regarding a particular issue, and that fund directors may rely on written and oral reports provided by fund management, auditors, and fund counsel, among others.

5 Section 36(a) of the 1940 Act permits the Commission to bring actions in federal court against directors that breach their fiduciary duties in respect of the funds that they oversee. The Commission cites *Strougo v. Scudder, Stevens and Clark, Inc.* 964 F.Supp. 783, 798 (S.D.N.Y. 1997) for the proposition that there is a private right of action under Section 36(a). However, the United States Court of Appeals for the Second Circuit has since ruled to the contrary in *Bellikoff v. Eaton Vance Corp.*, 481 F.3d. 110, 117 (2d Cir. 2007) (holding that implied private rights of action do not exist under Section 36(a) of the 1940 Act). While there are still cases in other circuits upholding private rights of action under Section 36(a) (*see*, e.g., *In re ML-Lee Acquisition Fund II, L.P.*, 848 F.Supp. 527, 542 (D. Del. 1994)), it is unclear if these cases would still be decided the same way in light of subsequent U.S. Supreme Court cases that restrict the ability of courts to find implied private rights of action in federal statutes (*see*, e.g., *Alexander v. Sandoval*, 532 U.S. 275 (2001)).

6 In addition to the use of soft dollars, the Release cites an adviser's use of an affiliate to execute trades, trade allocation among clients, and securities trades between clients as other trading-related conflicts that advisers often face.

7 *See* SEC Release No. 34-23170 ("*Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*") (April 23, 1986). Section V of this release states that in seeking best execution, advisers must seek 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 also supra*, footnote 2.

8 The Release states that implicit costs "may include, among other things, bid/ask spreads, the price impact of placing an order for trading in a security, and missed trade opportunity cost."

should "periodically and systematically evaluate the performance of broker-dealers handling its transactions." In accordance with Rule 206(4)-7 under the Investment Advisers Act (the "Advisers Act"), a registered investment adviser must have written policies and procedures designed to prevent violations of the Adviser's Act and the rules thereunder.[9] Moreover, Rule 38a-1 under the 1940 Act requires that a fund board approve annually the policies and procedures of the fund's investment adviser, based upon a finding that the policies and procedures are reasonably designed to prevent violations of the federal securities laws. Based upon the foregoing obligations, the Release suggests that a fund board seek information from the adviser to assist it in evaluating the adequacy of the best execution procedures, which should typically include data relating to:

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

In addition, the Release suggests that a fund board discuss the following with the adviser, as applicable:

- the adviser's process for making trading decisions and the factors involved in the selection of execution venues and broker-dealers;
- the means by which the 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 transaction costs are measured;
- how the quality of "execution-only" trades is evaluated compared to that of other trades (e.g., whether trades with a 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 adviser evaluates the quality of trade execution with respect to fixed income and other instruments traded on a principal basis; and
- how international trading is conducted and monitored.

Upon reviewing the applicable relevant information, a fund board should be able to determine whether the adviser's trading practices are in the best interest of the fund and its shareholders and satisfy its obligations under Rule 38a-1.[10]

Board Oversight of Use of Commissions

The Release explains the ways in which fund brokerage commissions may be used to benefit a

[9] Rule 206(4)-7 does not enumerate the elements that an adviser must include in these policies and procedures, but the Commission has stated that advisers should design their compliance programs based on the potential conflicts that they identify and has cited best execution as a topic that these programs should address. *See* SEC Release IA-2204 ("*Compliance Programs of Investment Companies and Investment Advisers*") (Dec. 17, 2003).

[10] Because of the constant evolution of trading practices, the Release stresses the need for fund board members to continue to educate themselves on this topic.

fund, including the adviser's acquisition of research in accordance with Section 28(e) of the Exchange Act or the utilization of a commission recapture arrangement or an expense reimbursement arrangement. An adviser's use of brokerage commissions (which are fund assets) to acquire soft dollar products and services creates potential conflicts of interest, and therefore must also be consistent with its fiduciary duties. The Release lists the following potential conflicts arising from this practice:

- it may relieve an adviser of having to produce or pay for research from its own resources;
- it may give an adviser an incentive to compromise its fiduciary obligations and to trade the fund's portfolio securities in order to earn soft dollar credits;
- it creates an incentive for an adviser to use broker-dealers on the basis of the research they provide rather than the quality of their execution;
- research obtained may benefit the adviser's other clients, including clients that do not generate brokerage commissions;[11]
- it may enable an adviser to charge advisory fees that do not fully reflect the costs for providing management services;
- it 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 from fund assets; and
- in the case of "mixed-use" products, an adviser has a conflict when allocating their value between the research (which is covered by the safe harbor) and non-research (which is not) uses, as is required under Section 28(e) of the Exchange Act.

The Release states that in spite of these potential conflicts, however, a fund board may conclude that the adviser's use of fund brokerage commissions to acquire soft dollar products and services is in the best interest of the fund.

[11] Such clients may include fixed income funds and funds and accounts that pay for execution only.

Section 28(e) of the Exchange Act

The Release cites the 2006 Release as providing the Commission's interpretive position regarding which "brokerage and research services" fall within the safe harbor created by Section 28(e).[12] With respect to Section 28(e), the Commission states that the board's responsibility is to have the adviser (i) inform it of the policies and procedures it relies on to ensure compliance with Section 28(e) and that portfolio trading is not excessive, and (ii) demonstrate to it that the commissions paid by the fund are reasonable in light of the services provided by the broker.

Board's Review of Investment Adviser's Policies and Procedures

In order for a fund board to determine that an investment adviser's use of brokerage commissions is in the best interest of the fund, the board needs to understand the adviser's procedures relating to brokerage commissions conflicts.[13] To this end, the Commission suggests in the Release that a board should ask the adviser for information regarding the following:

- how it determines the total amount of research to be obtained and how the research actually will be obtained;[14]

[12] As outlined in the 2006 Release, to make use of the Section 28(e) safe harbor an adviser must: (i) determine whether the product or service obtained is eligible research or brokerage under Section 28(e); (ii) determine whether the eligible product actually provides lawful and appropriate assistance in the performance of its investment decision-making responsibilities; and (iii) 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.

[13] The Release cites "broker votes", taken by the adviser's portfolio managers and analysts, as one method used by advisers to evaluate the quality of soft dollar products such as research received.

[14] Specifically, the Release suggests that board learn from the adviser how it determines the amount to be spent on research using hard versus soft dollars; how it determines amounts to be spent on proprietary versus third-party research arrangements; what types of research products and services it will seek and how this research will be beneficial to the fund; and how it determines amounts to be used in commission recapture programs and expense reimbursement programs.

- its process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program (e.g., whether a broker vote process or some other mechanism used);
- if any alternative trading venues used produce soft dollar credits, and if so, how much;
- how it determines that its use of soft dollars is within the Section 28(e) safe harbor;
- how soft dollar usage compares to its total commission budget;
- how it allocates soft dollar products and services among its clients;
- its process for assessing the value of the products or services purchased with soft dollars;
- its process used to evaluate the portion of a mixed-use product or service that can be paid for under Section 28(e); and
- to what extent it uses client commission arrangements.

Upon reviewing the appropriate information from the adviser, if the board does not believe that the adviser is optimally using the fund's brokerage commissions, it should "direct the adviser accordingly."[15] And in reviewing the adviser's policies and procedures, a board should specifically ask about how conflicts relating to portfolio trading are eliminated or mitigated.

Approval of Management Agreements

Section 15 of the 1940 Act requires a fund board to approve annually the fund's management agreement. The Release reiterates that this annual review should include an assessment of the soft dollar benefits received by the adviser from the fund's portfolio transactions, and states that a mere review of the soft dollar disclosure found in the adviser's ADV Part II would not suffice. Instead, it suggests that boards should at a minimum request "information regarding the adviser's brokerage policies, and how a fund's brokerage commissions, and, in particular, the adviser's use of soft dollar commissions, were allocated, at least on an annual basis."

Disclosure to Other Advisory Clients and Fund Investors

The Commission also took the opportunity to discuss the current state of soft dollar-related disclosure. The Release states that the Commission is currently seeking to improve the quality of disclosure provided by advisers in Part II of Form ADV.[16] The Commission also requests comment on whether further disclosure to fund investors of the information that boards should consider would be helpful; if any specific disclosure should be required to assist investors; and whether the dissemination of information regarding an adviser's trading practices would adversely affect an adviser's relationships with the broker-dealers executing portfolio transactions. Finally, the Commission asks whether advisers should provide their clients with customized information concerning how their individual brokerage is used.

Conclusion

In the Release, the Commission asserts that its proposed guidance would not impose new or additional requirements on fund boards, and that the guidance is intended to help boards fulfill their existing obligations. However, to the extent that current practices of fund boards and advisers fall

[15] In providing this direction, the Release suggests that the board consider: (i) whether the adviser should refrain from purchasing research services in connection with certain types of trades, depending on market conditions; (ii) whether the adviser should use fund brokerage commissions to receive brokerage and research services on some or all trades; (iii) whether fund brokerage commissions should be used only in connection with a commission recapture or expense reimbursement program; and (iv) whether some combination of these alternatives may be in the best interest of the fund.

[16] *See* SEC Release No. IA-2711, "*Amendments to Form ADV*" (March 3, 2008). The proposed amendments to Part 2 would require an adviser to disclose to clients: (i) that it receives a benefit because it does not have to produce or pay for the products and services; (ii) that it has an incentive to select broker-dealers based on its interests instead of clients' interests in receiving best execution; (iii) whether or not it pays up for soft dollar benefits; (iv) whether soft dollar benefits are used to service all of its accounts or just the accounts that paid for the benefits; and (v) the products and services it receives, describing them with enough specificity for clients to understand and evaluate possible conflicts of interest.

short of these proposed guidelines (and presumably the Commission believes that the efforts of many boards and advisers in this area do in fact fall short, or else there would be little need to issue this guidance), the practical result is very likely to be increased work for each. Once the Commission issues final guidance, fund boards will feel compelled to request and review all of the information that the SEC suggests is relevant. Thus, even if the Commission is not creating any new general obligations, the Release is defining the scope of these existing obligations broadly enough that, in most cases, much more will be required of fund boards and advisers.

However, it is unclear what form the final guidance from the SEC will take. The Commission seems particularly interested in soliciting input from the investment community regarding trading in general, advisers' use of fund brokerage, information that boards are (and should be) receiving, and potential disclosure enhancements. The responses to these queries should play an important part in shaping the Commission's final guidance to fund boards.

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