

## SEC Proposes Guidance for Investment Company Boards of Directors on Adviser Trading Practices

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The Securities and Exchange Commission (the SEC) approved proposed guidance (the Proposed Guidance) on July 30 on the duties and responsibilities of investment company boards of directors for a fund adviser's trading practices. The Proposed Guidance would supplement the SEC's July 2006 soft dollar interpretive release, and expressly states that it does not impose any new or additional requirements, although fund boards may disagree. Instead, according to the SEC, the Proposed Guidance is intended to assist fund directors in evaluating whether advisers have fulfilled their fiduciary obligations to the fund and have used the fund's assets in the fund's best interest. The SEC requested comment on the Proposed Guidance and whether additional disclosure requirements on the use of client commission arrangements are needed. Comments are due on the Proposed Guidance on or before October 1, 2008.

As noted, the SEC states that its Proposed Guidance "would not impose any new or additional requirements." Indeed, the SEC does not propose to alter its existing interpretations on soft dollar arrangements or propose any new disclosure requirements for advisers on soft dollar or other trading arrangements or funds in the form of additional prospectus disclosure. However, the SEC—through both its tone and its cataloguing of issues—is clearly upping the ante for fund boards in a way that is new. For example, the SEC states in the clearest of terms:

It is imperative that the fund's directors 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. Although directors are not required or expected to monitor each trade, they should *monitor* the adviser's trading practices and the manner in which the adviser fulfills its obligation to seek best execution when trading fund portfolio securities. In doing so, the fund's board should demand, and the fund's adviser must provide, all information needed by the fund's board to complete this review process. (Emphasis added; footnotes omitted.)

While fund boards have taken an increasingly active role in evaluating adviser trading practices in recent years, the Proposed Guidance contemplates a more "hands-on role" for many fund boards. If the Proposed Guidance's statements that fund boards must "scrutinize" and "monitor" adviser trading and "determine [that] the adviser's trading practices are being conducted in the best interests of the fund and the fund's shareholders" are interpreted to require a board to "micromanage" the adviser's trading, that would, of course, be a new and additional requirement that goes well beyond the traditional oversight of

fund boards.

The Proposed Guidance sets out information that directors should request from advisers about their policies, procedures, and processes for achieving best execution and using fund brokerage commissions. Directors may use that information to determine whether an adviser's trading practices are in the best interests of funds and their shareholders. The Proposed Guidance also highlights key conflicts of interest that directors should evaluate to determine whether the use of fund brokerage commissions by an adviser is in the best interests of a fund. In addition, the Proposed Guidance notes that fund boards should consider an adviser's receipt of soft dollar benefits in assessing the adviser's compensation.

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

The Proposed Guidance notes that a fund's board should have sufficient information about an adviser's trading practices to satisfy itself that the adviser is fulfilling its fiduciary obligations and acting in the best interests of the fund. When trading for a fund, advisers should consider how to minimize overall transaction costs, such as by using alternative trading systems such as "dark pools," advanced mathematical models or algorithmic trading systems, and crossing networks.

Boards should seek data including: (i) the identification of broker-dealers the fund uses; (ii) the commission rates or spreads paid; (iii) the allocation among broker-dealers of commissions and the value of trades executed; and (iv) the fund's portfolio turnover rates.

Boards also should discuss the following points with the adviser, and direct advisers accordingly if the adviser's trading practices are not in the best interests of the fund or its shareholders:

- How the adviser makes trading decisions and selects execution venues and broker-dealers
- How the adviser determines best execution and evaluates execution quality and the impact of alternative trading systems on best execution
- How commission rates are negotiated, whether the amount of commissions depends on comparative data, and how transaction costs are measured
- How the quality of "execution only" trades is evaluated compared to that of other trades
- How the performance of the adviser's traders and broker-dealers is evaluated, how the aggregate performance of a firm's traders is evaluated, and how problems or concerns with a trader or broker-dealer are addressed
- How the adviser oversees and monitors sub-advisers, including the trading intermediary selection process
- To what extent and under what conditions the adviser uses affiliated broker-dealers
- How fixed-income securities are traded and how trading costs are determined
- How the quality of trade execution is evaluated for fixed-income and other securities traded on a principal basis
- How international trading activities are conducted and monitored.

### **Board Oversight of Adviser Compliance Policies and Procedures**

The Proposed Guidance notes that boards may evaluate an adviser's best execution and soft dollar policies and procedures using different sources, including the fund's or adviser's chief compliance officer. Boards should ask the adviser to tell the board about the methods it uses to ensure that the brokerage and research services purchased with soft dollars fall within the safe harbor of Section 28(e) of the Securities Exchange Act of 1934. In addition, the Proposed Guidance notes that, due to the

proliferation of trading venues, boards need to remain up to date in their knowledge of new trading markets. Boards should ask the adviser about the following:

- How does the adviser determine the total amount of research to be obtained and how will research actually be obtained?
- What is the process for establishing a soft dollar budget and determining brokerage allocations in the soft dollar program?
- Do any alternative trading venues that are used produce soft dollar credits and, if so, how much?
- 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?
- How does the adviser assess the value of soft dollar products and services?
- How does the adviser 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, and what effect do these arrangements have on how the adviser selects broker-dealers? How does the adviser explain that the use of client commission arrangements benefits the fund?

### **Board Evaluation of Adviser Conflicts of Interest Relating to Soft Dollars**

The Proposed Guidance discusses the potential conflicts of interest that may arise when an adviser uses client commissions to obtain research and related services that it would otherwise have to pay for (i.e., with "hard dollars"). Boards should consider whether soft dollar arrangements are in a fund's best interest in light of the following potential conflicts of interest:

- Using soft dollars relieves an adviser from producing the research itself or paying for it with hard dollars
- Using soft dollars may give the adviser an incentive to compromise its fiduciary obligations and trade the fund's portfolio in order to earn soft dollar credits
- The availability of soft dollar benefits may cause an adviser to select broker-dealers based on research rather than execution quality
- Advisers may use soft dollars to obtain research that benefits its other clients
- Using soft dollars may disguise an adviser's true costs and enable an adviser to charge advisory fees that do not fully reflect its costs for providing advisory services
- Using soft dollars may cause an adviser to avoid other uses of fund brokerage commissions that may be in the fund's best interest, such as the establishment of commission-recapture programs or fund-reimbursement arrangements
- An adviser must allocate the research and nonresearch use of mixed-use products and determine how much of the cost the adviser will pay for with hard dollars.

After these reviews, if the board believes that the adviser could have used the fund's brokerage commissions to provide a greater benefit to the fund, the board should direct the adviser accordingly. Directors should consider, and the adviser should explain, how the policies and procedures eliminate or mitigate the conflicts of interest discussed above, and whether the adviser has met its best execution obligation and appropriately used fund assets.

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