

## Summary: August 21, 2008 Conference Call

On July 30, 2008, the SEC issued proposed guidance regarding the duties and responsibilities of mutual fund boards of directors with respect to the oversight of investment advisers' trading practices. Among other things, the proposed guidance relates to a mutual fund board's oversight responsibilities with regard to the fund's portfolio manager's use of brokerage commissions to purchase research services. Investorside's regulatory update conference call on August 21, 2008 featured a discussion of this proposed SEC guidance by Will Edick of the Washington, DC law firm of Pickard and Djinis LLP, securities regulatory counsel to Investorside.

Mr. Edick noted that the research industry has been anticipating this release for some time, as the SEC has been discussing its plans to formulate a release regarding disclosure and transparency issues relating to Section 28(e) soft dollar arrangements since its 2006 Section 28(e) release, and only recently addressed some of these issues in its proposed changes to Form ADV. He generally characterized the recently proposed guidance as good news for the industry. The proposed guidance should provide a degree of certainty and comfort to fund directors who may previously have had a degree of skepticism with regard to client commission practices. While the SEC has emphasized that its proposed guidance does not and would not impose any new obligations on fund boards, Mr. Edick expressed his hope that the SEC's comment process with regard to the proposed guidance, which runs until October 1, 2008, could be used to smooth out any potential confusion which could be caused by the length and breadth of the proposed release.

Mr. Edick summarized the contents of the release, beginning with the first section, which generally discusses the fiduciary obligations of fund directors. Fund boards are subject to duties under state law as well as the Investment Company Act of 1940 (the "Company Act"). Under state law, directors are subject to a duty of care and a duty of loyalty. The duty of care requires directors to perform their oversight responsibilities with the care of an ordinarily prudent person in a similar position under similar

circumstances, and the SEC has interpreted this duty to mean that a fund board should be reasonably informed about an issue before making a decision on that issue, and about the activities of the fund and its adviser. The SEC indicated that the board may rely on the chief compliance officer of the fund, as well as other experts retained by the fund, to provide information to the board. The duty of loyalty requires directors to act in the best interests of the fund, avoid conflicts of interest

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with the fund and avoid putting their own interests before those of the fund and its shareholders. The release then discusses directors' fiduciary obligations arising under the Company Act, which

include a duty to monitor the conflicts of interest facing the fund's investment adviser and determine how to manage such conflicts, as well as a duty to review and approve the adviser's contract with the fund. With regard to how the fiduciary obligations of fund directors differ from those of other fiduciaries, Mr. Edick noted that while state and common law fiduciary duties would apply to any fiduciary, such as a trustee, those duties arising under the Company Act apply only to investment companies. However, he noted that other, more restrictive duties, such as those arising under ERISA, apply to other fiduciaries, such as pension fund trustees.

Mr. Edick then discussed the portion of the release relating to fund boards' oversight responsibilities. Noting that it appears clear that the SEC treats both proprietary and third-party research arrangements

equally under Section 28(e), he emphasized that fund boards should scrutinize each type of arrangement equally. He also noted that the proposed guidance makes clear that a number of different arrangements into which advisers frequently enter, such as commission recapture programs and expense reimbursement programs in addition to client commission arrangements, are proper as long as the fund board carries out its oversight responsibilities.

The first oversight responsibility addressed in the release is a director's duty to oversee the fund manager's best execution responsibilities. Investment advisers must execute securities transactions in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances. The release, which does not change any existing interpretations of best execution responsibilities, indicates that an adviser should consider direct costs (such as transaction costs), implicit costs (such as spreads and price impact), opportunity costs and the utility of research obtained from the executing broker in determining its best execution responsibilities.

The proposed guidance identifies certain actions a fund board should take in order to comply with its obligation to oversee the fund manager's compliance with its best execution obligations. Specifically, the SEC indicated that a fund board should typically request several types of information, including the identity of brokers to whom the adviser allocates trades; the commission rates or spreads paid to such brokers; the total brokerage commissions and value of securities allocated to a particular broker-dealer over a particular period; and the fund's portfolio turnover rates. The SEC further indicated that fund boards may wish to discuss certain additional matters, such as the process behind the adviser's trading decisions and the factors involved in selecting broker-dealers and execution venues, the means by which the adviser determines best execution, how the quality of "execution only" services are evaluated compared to trades with broker-dealer who also provide other services, how sub-advisers are monitored and how the adviser monitors fixed income and international securities trading. In response to a

question regarding how this guidance differs from current oversight practices, Mr. Edick expressed his view that it does not differ from current practice, and noted that many fund boards ask more questions of the fund's adviser than those provided by the SEC. He also noted that the SEC's guidance appears to have some flexibility, and does not appear to increase the oversight burden on fund directors.

The proposed guidance also discusses boards' oversight of the adviser's use of fund brokerage. In this regard, the release sets forth a number of conflicts of interest that may, in the SEC's view, arise where an adviser uses fund commissions in soft dollar arrangements. Such conflicts include the fact that the use of fund brokerage to pay for research may relieve the adviser of the responsibility to produce research internally or pay for research using hard dollars; the fact that the

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availability of soft dollar research may create the incentive for the adviser to use a particular broker-dealer based on the quality of its research rather than the quality of its execution; the fact

that obtaining research may cause the adviser not to engage in other programs, such as commission recapture programs; and the conflicts associated with mixed-use items. Mr. Edick expressed his view that some of the conflicts identified by the SEC may be overstated, and further noted an apparent misconception that soft dollar benefits primarily flow to the adviser, when in fact soft dollar services typically benefit the adviser's clients. It is anticipated that the SEC will receive public comments in opposition to some of these stated conflicts.

The next section of the proposed guidance discusses the steps a fund board should take to oversee Section 28(e) soft dollar arrangements. The SEC indicated that the board bears a duty to satisfy itself that the adviser is utilizing the Section 28(e) safe harbor properly and to examine how the adviser uses client commissions in soft dollar arrangements. The release notes that the adviser should provide certain information to fund boards, including a description of how the adviser determines the total amount of research it needs or uses for the fund and how it will pay for such research; whether the adviser will use proprietary or third-party

research; and whether it will obtain research through Section 28(e) arrangements or pay through its own pocket. The SEC also recommends that a board ask for certain additional information from the fund manager, such as information about the adviser's practices with regard to establishing a research budget and determining which broker will provide the adviser with research; how the adviser determines its own compliance with the Section 28(e) safe harbor; how the adviser's client commission arrangement budget compares to its overall budget (such as for execution-only services or expense reimbursement programs); and how research obtained through Section 28(e) arrangements is distributed across client accounts (i.e., how the adviser divides such research among private clients, hedge fund clients and mutual fund clients). In response to a question as to whether the steps suggested by the SEC go beyond the requirements of Section 28(e), Mr. Edick indicated that he does not think these steps do go beyond such requirements. Noting that Section 28(e) applies to the adviser, Mr. Edick expressed his view that some of the questions identified by the SEC relate to areas that may not be appropriate for fund board inquiry, such as the adviser's practices in allocating research among accounts (which appears to run counter to the protection afforded advisers by the Section 28(e) safe harbor against being required to make such an allocation across accounts).

Finally, the release discusses a fund board's obligation to review and approve advisory contracts. This responsibility requires such review and approval both before the fund initially enters into the advisory contract and prior to the renewal of the contract on at least an annual basis. Under the SEC's proposed guidance, fund directors should consider the value of the benefits received by the fund's adviser through soft dollar arrangement when determining whether the adviser's compensation is justified. Mr. Edick again noted the SEC's apparent underlying assumption that soft dollar arrangements benefit the adviser, and asserted that such arrangements are typically designed to benefit the underlying client. He expressed hope that this particular aspect of the release would be revised in response to comments received by the SEC.

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A brief question-and-answer session followed Mr. Edick's presentation. The first question concerned whether it is appropriate for the SEC to suggest that a fund board must consider the fund adviser's receipt of soft dollar benefits when determining whether to approve the advisory contract. He stated his view that it is not appropriate, as such a requirement assumes that soft dollar benefits functionally compensate the adviser, an assumption with which he disagrees. In response to a question regarding whether the proposed guidance will further confuse fund directors, Mr. Edick expressed hope that the release will clarify the legitimacy of both proprietary and third-party research arrangements and will generally provide more certainty to fund boards. He then responded to a question regarding the effect of the release on hedge fund managers by noting that the proposed guidance would not apply to such advisers to the extent they do not manage mutual funds, and that the release will not change the ability of such hedge fund managers to receive soft dollar benefits outside the Section 28(e) safe harbor provided proper disclosure is made.

Another question asked whether the proposed release has the potential to cause a chill in soft dollar programs for third-party research providers. Mr. Edick opined that it likely would not, as fund boards should be given comfort by the final guidance. He then addressed a question regarding directors' Section 15(c) requirement to approve the fund manager's advisory contract which asked whether boards currently utilize any procedures to determine the value of soft dollar research to investment advisers. Mr. Edick stated his understanding that such a determination is not something that fund boards typically address in the context of reviewing an adviser's compensation and his opinion that boards should not be required to make such a value determination.

Finally, in response to a question concerning the potential effect of the release on proprietary research, Mr. Edick again reiterated that the release makes very clear that both proprietary and third-party research should be subjected to equal scrutiny, and that the release should not have any effect other than to provide some comfort to fund boards. ■