INVESTMENT ADVISER
ASSOCIATION

October 1, 2008

Via Electronic Filing

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090

Re: Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices, SEC Rel. Nos. 34-58264; IC-28345; IA-2763; File No. S7-22-08

Dear Ms. Harmon:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Commission's proposed guidance for mutual fund boards of directors with regard to their responsibilities in overseeing the activities of investment advisers' trading of fund portfolio securities.[2] Investment advisers are fiduciaries to the funds they manage. We recognize that execution of fund transactions, in keeping with the adviser's best execution obligations and the related receipt of brokerage and research services, is an important issue for funds and their shareholders, and is an important area of oversight for fund boards.

The IAA supports the Commission's goal of providing guidance to assist fund directors with their oversight of these issues. Fund advisers facilitate this oversight process by providing fund boards with robust disclosure on their policies and procedures and a broad array of information on fund portfolio transactions. While the Commission's overall guidance in this area is constructive, we are concerned that the negative tone toward soft dollar arrangements implicit in the Proposed Guidance may lead to a presumption that soft dollar arrangements are inappropriate for funds in the first instance. We urge the Commission to incorporate a more balanced discussion of soft dollar arrangements in its final guidance. In addition, we offer the following recommendations and comments:

[1] The Investment Adviser Association (formerly the Investment Counsel Association of America) is a not-for-profit association that represents the interests of SEC-registered investment advisory firms. Founded in 1937, the IAA's membership today consists of more than 500 firms that collectively manage in excess of $9 trillion in assets for a wide variety of individual and institutional clients. For more information, please visit our web site: www.investmentadviser.org.

[2] *See Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices*, SEC Rel. Nos. 34-58264; IC-28345; IA-2763; File No. S7-22-08 (July 30, 2008) ("Proposed Guidance" or "guidance"), available at http://www.sec.gov/rules/proposed/2008/34-58264.pdf.

- The Commission should emphasize that the guidance is not a mandatory checklist;
- The Commission should revise certain information requested for review of the fund adviser's best execution obligations;
- The guidance should be viewed in the context of Rule 38a-1; and
- The Commission should continue to rely on Form ADV, Part 2 as the appropriate vehicle for broader adviser soft dollar disclosure.

1. The Guidance Should Provide a More Balanced Discussion of Client Commission Arrangements

In 2006, the Commission issued detailed guidance regarding the use of soft dollars.[3] Since issuing that release, the Commission has continued to recognize the utility of soft dollar arrangements with appropriate disclosure. Indeed, the Commission recently stated that: "[o]ur intent is not to create a negative impression regarding soft dollars [sic] arrangements, but rather to require full disclosure of [soft dollar] arrangements that we believe involve significant conflicts of interest."[4] Nevertheless, the Proposed Guidance, taken as a whole, appears to impart a negative tone toward soft dollar arrangements. The Commission's inclusion of lengthy, detailed checklists of questions and requests for information as well as various recommendations that the board consider whether it is appropriate for the adviser to refrain from using fund brokerage commissions to receive brokerage and research services create an impression that soft dollar arrangements are inappropriate for funds. Thus, the Proposed Guidance tacitly encourages fund directors to prohibit or restrict advisers' use of fund brokerage to obtain eligible research and brokerage services.[5]

Further, while the Proposed Guidance highlights the potential conflicts of interest an adviser may face in soft dollar arrangements, we believe it does not acknowledge the benefits of soft dollar arrangements to advised clients overall. For example, the Commission states that "without 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 that the board believes should be paid for by the adviser rather than with fund assets."[6] We believe discussion of potential conflicts of interest should be balanced by discussion of the positive aspects of soft dollar arrangements for fund directors' consideration. The Commission should include acknowledgment of the benefits to advisory clients of valuable

[3] *Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934,* SEC Rel. No. 34-54165 (July 18, 2006) ("2006 Release"), available at http://www.sec.gov/rules/interp/2006/34-54165.pdf.

[4] *Amendments to Form ADV,* SEC Rel. Nos. IA-2711; 34-57419 (Mar. 3, 2008) ("Form ADV, Part 2 Reproposal") at 34.

[5] *See, e.g.,* Proposed Guidance at 25 n.68, 28, 32.

[6] *Id* .at 5.

brokerage and research services, as it did in the 2006 Release.[7] The final guidance should also more prominently highlight that the interests of a fund's adviser and the fund are aligned in the regard because advisers have an incentive to minimize transaction costs.[8]

In addition, even if a fund were to instruct an adviser to refrain from using any brokerage to pay for research, it may not result in a reduction of commission costs for that fund. Advisers are continually evaluating the performance of broker-dealers and commission rates to seek best execution, rather than focusing solely on the lowest possible commission costs. For example, to satisfy its best execution obligation, an adviser may conclude it needs to pay more than an execution-only rate so that a broker would be willing to commit capital, thereby reducing the overall explicit costs of execution. The Proposed Guidance seems to articulate a misperception that execution cost is the smallest component of a commission cost, with the remainder paid for research. Instead, however, execution cost may be the largest component of the commission rate.

Similarly, the Proposed Guidance appears to take a negative view of advisers' use of client commissions to obtain research that benefits other clients' accounts, even though Section 28(e) contemplates such practice.[9] The Proposed Guidance describes such practices as a conflict of interest.[10] It further suggests that directors satisfy themselves that "the fund is not subsidizing the research needs of the adviser's other client."[11] Under Section 28(e), however, an adviser is permitted to determine that brokerage and research products and services received benefit all accounts for which it exercises investment discretion.[12] The Commission appears to articulate a new standard in the Proposed Guidance for compliance with the Section 28(e) soft dollar safe harbor by requiring fund directors to evaluate how soft

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[7] *E.g.*, 2006 Release at 49-50 (discussing how soft dollar arrangements benefit clients by providing valuable research ideas and greater breadth and depth of research); 2006 Release at 52 (describing the variety of arrangements developed to seek to obtain the benefits that inure to investors from best execution and providing money managers with brokerage and research products and services of value to advised accounts); response of Division of Investment Management Director Andrew Donohue to questions by Chairman Cox at Open Meeting proposing the guidance (July 30, 2008) ("Open Meeting") (discussing value of research), archive available at: http://www.sec.gov/news/openmeetings.shtml.

[8] Proposed Guidance at 24 n.5.

[9] *See, e.g., Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds,* SEC Office of Compliance Inspections and Examinations ("OCIE") (1998) at 35, 43.

[10] Proposed Guidance at 24.

[11] *Id*. at 30. *See also id.* at 32 (the adviser should explain to the board whether the services purchased with fund commissions are inappropriately benefiting another of the adviser's clients at the fund's expense). *See also id.* at 35-36 (directors should undertake similar analysis in connection with the Investment Company Act Section 15(c) review).

[12] *See, e.g.*, 2006 Release at 48.

dollar products and services are allocated among the adviser's clients.[13] This position is inconsistent with the Commission's statement that the Proposed Guidance would not impose any new or additional requirements.

In addition, the Commission's focus on allocating soft dollar benefits among advisory clients does not reflect how research is used within firms. Soft dollar credits from specific accounts are not allocated to specific products. Generally, advisers do not limit research, internally generated or obtained through soft dollar arrangements, to any particular client or segment of their clients. Typically, all research resources are shared among the adviser's portfolio managers and can be used for the benefit of all discretionary clients of the firm. Indeed, some advisers may not agree to manage a fund portfolio if the fund directs the adviser to restrict the research the adviser uses in managing the fund's portfolios. As a practical matter, fund commissions may be used to obtain research that benefits other clients and other clients' commissions may be used to obtain research that benefits the fund. For these reasons, we urge the Commission to revise its language in this regard in the final guidance and acknowledge that fund boards may determine that the fund benefits from the adviser's soft dollar arrangements.

2. The Commission Should Emphasize that the Guidance Is Not a Mandatory Checklist

The Proposed Guidance is provided for fund directors to "consider in performing their responsibilities and in determining what is appropriate in light of their fund's particular circumstances."[14] We agree that the guidance should be applied flexibly and tailored to the specific circumstances of the funds and their advisers. However, throughout the Proposed Guidance, the SEC uses obligatory terms such as "should," which may imply an industry-standard, check-the-box framework for fund boards. In this regard, several Commissioners at the Open Meeting expressed concern that the guidance not be interpreted as simply a checklist for directors, their counsel, and OCIE.[15] We respectfully request that the Commission address these concerns in the final guidance and use terms such as "may consider" rather than "should" when identifying suggested factors.

3. The Commission Should Revise Certain Information Requested for Board Review of the Adviser's Duty of Best Execution

As a fiduciary, an investment adviser has an obligation to seek best execution in connection with client transactions and to disclose potential conflicts of interest to existing and prospective clients. The duty of best execution requires an adviser to seek to execute securities transactions for clients in such a manner that the client's total cost or proceeds is the

[13] Proposed Guidance at 30.

[14] *Id.* at 7.

[15] *See* Open Meeting *supra* n.7 (comments of former Commissioner Atkins and Commissioner Casey at the open meeting).

most favorable under the circumstances.[16] Advisers may consider a variety of factors in determining the most favorable terms such as execution price, commission rate (if applicable), potential market impact, the full range and quality of a broker's services, the value of research provided, financial responsibility, and responsiveness to the adviser. The determinative factor is not the lowest possible commission cost but whether the transaction represents the best qualitative execution for the managed account.[17] A best execution analysis is a systematic process including policies and procedures to evaluate the execution performance of broker-dealers executing transactions. Indeed, the Commission recognizes that "in consideration of the wide variety of advisers in terms of size and operations, each adviser should determine what trading intermediary selection process is most appropriate for its circumstances."[18] Given these considerations, many fund boards have thoughtfully considered the information that they deem necessary for their oversight, and have designated reporting to meet their needs for the funds they oversee, and for their particular areas of interest or concern.

The Commission's Proposed Guidance now implies, however, that to evaluate best execution policies and procedures, directors must seek specific data from the fund's adviser, including lists of broker-dealers to which the adviser allocates brokerage, commission rates and spreads, total commissions allocated to each broker-dealer, and portfolio turnover rates. We are concerned that the suggested data does not reflect the characteristics of equity or fixed-income trading, may be difficult to gather or estimate, and may not assist fund directors in evaluating the adviser's best execution process for the reasons discussed below.

First, a list of all broker-dealers used for the fund or for all of the adviser's accounts is not necessarily helpful for fund directors to evaluate the best execution process. Advisers may use hundreds of broker-dealers over the course of a year for a particular fund depending on the mandate and asset class involved, and some may be used only infrequently to meet a particular need. This specific information does not illuminate the best execution process any better than a description of how many brokers are used and under what general circumstances or factors.

Second, if the Commission proceeds with having boards request lists of broker-dealers, it should reconsider its language referencing allocation of brokerage. Advisers may not allocate brokerage in advance to particular broker-dealers on a pre-determined allocation formula or percentage target basis. In the fixed-income market in particular, the market

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[16] *See Interpretive Release Concerning the Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, SEC Rel. No. 34-23170 (Apr. 23, 1986), 51 Fed. Reg. 16004 (Apr. 30, 1986) ("1986 Release") at Section V. *See also* 2006 Release at n. 149; *see also Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs*, Rel. No. IC-26313 (Dec. 18, 2003) ("Transaction Costs Release") at 16 ("[a]lthough a mutual fund's investment adviser has an obligation to seek the best execution of securities transactions arranged for or on behalf of the fund, the adviser is not necessarily obligated to obtain the lowest possible commission cost.")

[17] 1986 Release.

[18] Proposed Guidance at 16.

operates on a principal basis rather than an agency basis like most equity trading. Thus, variations between brokers in this market can be much larger due to differences in dealer inventory and their willingness to compete for business. Selection of counterparties is generally based on numerous factors, such as the asset class, the portfolio manager's experience, the broker-dealer's responsiveness, the broker-dealer's willingness to commit capital, and other non-monetary factors. Thus, the Commission may wish to reframe this request to solicit information regarding "broker-dealers that the adviser has used for trading" over a certain past period.

Third, advisers managing fixed-income portfolios cannot provide information about the "spreads paid" nor is that type of information available from brokers. Advisers in the fixed-income market buy and sell out of dealer inventory, and therefore, are not in a position to know the amount originally paid by a dealer for a security, spreads paid if the dealer has a corresponding client for a particular bond on the opposite side of a trade, the amount of a mark-up (if any), or the implicit or explicit costs.[19] Thus, we request the Commission delete this request in the final guidance. Likewise, we request the Commission to eliminate or clarify its suggestion that directors discuss with advisers how they determine "the costs of fixed income transactions," as it is not clear to what and to whom the costs relate.[20]

Fourth, the Commission's recommendation that fund boards request information on specific commissions or spreads may imply that advisers and boards are required to conduct transactional analysis of best execution on a trade-by-trade or account-by-account basis. Advisory firms may meet their best execution obligations without conducting analyses on a trade-by-trade or account-by-account basis. Rather, advisers may evaluate broker performance based on asset type, the particular market, and overall performance. Acknowledging this fact, the Commission itself states that "directors are not required or expected to monitor each trade."[21] Instead of creating a presumption that advisers should provide specific commission or spread data or other statistical trade data, we request the Commission's final guidance suggest that advisers provide an overview of their trading practices, and if the board deems appropriate, data such as the most frequently used brokers, total commissions, or other aggregate data.

Finally, certain statements in the Proposed Guidance may incorrectly imply that advisers determine whether to engage in client-directed brokerage arrangements. For example, the Proposed Guidance states that an "adviser may utilize a commission recapture arrangement, whereby the fund receives a portion, or rebate, of the brokerage commission (or

[19] While there may be vendors that compare market data with their own proprietary database, such services may be extremely costly and not particularly useful in the best execution analysis. A comparative analysis of execution costs alone does not take into account the other factors in a best execution review and, therefore, such after-the-fact analysis does not necessarily flag best execution issues.

[20] Proposed Guidance at 19.

[21] *Id.* at 5.

spread) charged by the broker-dealer handling the trade."[22] However, a fund, not its adviser, determines whether to enter into a commission recapture arrangement and to direct the adviser to use a particular broker-dealer for the fund's portfolio transactions. As the Commission noted previously, "in evaluating commissions, fund directors also consider the appropriateness of entering directed brokerage arrangements."[23] More recently, the Commission stated, "[w]e understand that these [commission recapture] programs are not typically sponsored or promoted by advisers, but are more likely driven by client demands."[24] Accordingly, the Commission should eliminate statements in the final guidance implying that advisers determine whether to use and the amounts to be used in commission recapture programs directed by fund clients.

4. The Guidance Should Be Viewed in the Context of Rule 38a-1 Reviews

Fund directors' review of advisers' trading practices is a critical component of the approval process of compliance policies and procedures and compliance program rule reviews under Rules 38a-1 under the Investment Company Act of 1940 and Rule 206(4)-7 under the Investment Advisers Act of 1940.[25] The Proposed Guidance should not be viewed as suggesting a separate or additional evaluation process for boards apart from the Rule 38a-1 process. The fund chief compliance officer must annually furnish the board with a written report of the operation of a fund's and its service providers' policies and procedures. The process of these annual reviews includes an identification of material compliance matters and recommendations for material changes to policies and procedures, including with respect to best execution and soft dollar arrangements. Further, many fund directors already receive robust reporting of soft dollar arrangements by the fund's adviser in conducting their Investment Company Act Section 15(c) review of the fund's advisory agreement.

We encourage the Commission to align the final guidance with the framework of directors' obligations under Rule 38a-1 in approving the adviser's policies and procedures with regard to best execution and soft dollar arrangements. This context will also help avoid elevating best execution and soft dollars disproportionately above other important issues directors must monitor, such as valuation. The Commission should confirm that fund boards

[22] *See id.* at 22 and n. 62. *See also, id.* at 29 (suggesting factor asking adviser about how it determines the amounts to be used in commission recapture programs).

[23] *See* Transaction Costs Release at 16.

[24] Form ADV, Part 2 Reproposal at 33.

[25] The rules are designed to protect investors by ensuring that all funds and advisers have internal programs to enhance compliance with the federal securities laws. *See Compliance Programs of Investment Companies and Investment Advisers*, SEC Rel. Nos. IA-2204; IC-26299 (Dec. 17, 2003). Under Rule 38a-1, fund boards must approve the fund's compliance policies and procedures based on a finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws by the fund and its investment adviser. Advisers are required under Rule 206(4)-7 to implement policies and procedures reasonably designed to prevent violations of the Advisers Act.

may be deemed to have satisfied their fiduciary duties if their Rule 38a-1 review concludes that the adviser's policies and procedures are reasonably designed to prevent violations of the securities laws governing best execution and soft dollar arrangements.

5. Form ADV, Part 2 Is the Appropriate Vehicle for Soft Dollar Disclosure

The Commission seeks comment on whether investment advisers should provide additional disclosures to mutual fund investors or other clients of advisers, beyond the proposed disclosure in Form ADV, Part 2. The Commission also seeks comment on whether it should re-propose a report of brokerage practices for advisers that applies across accounts and would be publicly available, originally proposed in 1995.[26]

The IAA has consistently supported full and appropriate disclosure of advisers' soft dollar practices, arrangements, products and services obtained, and any conflicts of interest, including the SEC's proposed Form ADV disclosure requirements for soft dollar arrangements.[27] The ADV proposal requires advisers to disclose their soft dollar practices and discuss the conflicts of interest they create. The detailed disclosure in the ADV proposal will permit clients to evaluate their advisers' use of client commissions and whether the adviser has adequately addressed any potential conflicts of interest. We believe the proposal clearly addresses the Commission's goal of increased transparency and accountability with respect to brokerage commission practices.

Consistent with our 1995 comment letter, we continue to oppose requiring a separate report on brokerage practices as an unnecessary and inflexible exercise that would not ultimately benefit clients. The disclosure proposed in 1995 would have imposed costs and burdens on advisers while overwhelming clients with largely immaterial information that they have not requested and do not desire. Instead, clients should be permitted to request additional disclosures and information that they consider important. A reporting requirement focusing on two elements of execution, brokerage commissions and research, instead of the full range and quality of a broker's services, would inappropriately highlight only a few factors involved in execution rather than the entire trading circumstances at the time. Further, public dissemination of information regarding the rates a particular broker is charging for client transactions could have a harmful competitive impact on the adviser's negotiation with

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[26] The Commission cites its 1995 proposal *Disclosure by Investment Advisers Regarding Soft Dollar Disclosure*, SEC Rel. Nos. 34-35375; IA-1469 (Feb. 14, 1995), as a potential model. The IAA submitted a comment letter on the proposal. *See* Letter to Jonathan G. Katz, SEC, from Douglas M. Loudon, President, ICAA, May 16, 1995.

[27] *See* Letter to Nancy M. Morris, SEC, from Karen L. Barr, General Counsel, and Valerie M. Baruch, Assistant General Counsel, IAA, May 16, 2008, available at http://www.investmentadviser.org/public/letters/comment051608.pdf. The IAA opposed, however, the proposed provision that would require advisers to disclose whether they seek to allocate soft dollar benefits to client accounts proportionately to the soft dollar credits the accounts generate, for many of the reasons articulated above. *See also* Letter to Chairman Cox from David G. Tittsworth, IAA Executive Director, Aug. 26, 2008, available at http://www.investmentadviser.org/public/letters/comment082608.pdf.

other brokers regarding commission rates. These types of problems contributed to the Commission's abandonment of its 1995 proposal.

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The IAA greatly appreciates your consideration of our comments on the Proposed Guidance. Please do not hesitate to contact the undersigned or Karen L. Barr, IAA General Counsel, if we may provide additional information or assistance to you regarding these matters.

Sincerely,

/s/ Monique S. Botkin

Monique S. Botkin
Senior Counsel

cc: The Honorable Christopher Cox, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
Mr. Andrew J. Donohue
Mr. Thomas R. Smith