MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

October 1, 2008

Ms. Florence E. Harmon
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors With Respect to Investment Adviser Portfolio Trading Practices, File No. S7-22-08

Dear Ms. Harmon:

The Mutual Fund Directors Forum ("the Forum")[1] appreciates the opportunity to comment on guidance that the Securities and Exchange Commission ("Commission" or "SEC") is proposing to offer mutual fund directors regarding "The Duties and Responsibilities of Investment Company Boards of Directors With Respect to Investment Adviser Portfolio Trading Practices."[2]

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors and serves as an independent vehicle through which Forum members can express their views on matters of concern.

As we discuss below, the Commission's Proposed Guidance appropriately recognizes the key role that directors play in overseeing both funds' use of soft dollars and advisers' efforts to obtain best execution on behalf of funds. The Proposed Guidance also correctly emphasizes that

---

1 The Forum's current membership includes over six hundred independent directors, representing seventy-nine independent director groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 Proposed Commission Guidance: The Duties and Responsibilities of Investment Company Boards of Directors With Respect to Investment Adviser Portfolio Trading Practices, File No. S7-22-08, Investment Co. Act Rel. No. 28345 (July 30, 2008) [73 FR 45646 (Aug. 6, 2008)] ("Proposed Guidance").

directors need to be fully educated about these issues and that they must obtain from advisers the information necessary to fulfill their oversight function.

Given the critical role that directors play in overseeing the use of soft dollars, it is crucial that the Commission not only provide directors with appropriate guidance, but most importantly, that it recognize the importance of directors' business judgment in managing these conflicts and that it protect their informed exercise of that business judgment. As we discuss below, however, the Proposed Guidance fails to advance these important goals.

Comments

I. Proposed Soft Dollar Guidance

The use of soft dollars by funds, as the Commission's Proposed Guidance recognizes, poses numerous conflicts. We agree with the Commission that the primary conflicts are the risks (i) that the adviser will use fund assets to pay for research that it would otherwise be paying for or producing itself; (ii) that the adviser will trade the fund's portfolio more than would otherwise be the case in order to generate additional soft dollars; (iii) that the adviser will use research obtained through soft dollars to benefit clients other than the fund that was the source of the soft dollars, particularly in circumstances in which the fund generating the soft dollars is not benefitting in any material way from the research; and (iv) that the adviser will pick execution brokers based on the availability of soft dollar benefits rather than the cost and quality of the execution services offered.[3]

Because of our concern over these conflicts, a majority of the members of the Forum have historically opposed soft dollar usage by funds,[4] and the Forum has therefore consistently encouraged the Commission to take the necessary action, either regulatory or legislative, to achieve this result. A majority of our members continue to believe that, because of the difficulty

---

[3] *See* Proposed Guidance at 45652 – 45653. We identified essentially the same conflicts in our 2004 Best Practices report for independent fund directors. *See Report of the Mutual Fund Directors Forum: Best Practices and Practical Guidance for Mutual Fund Directors* (July, 2004) [hereinafter "*Best Practices"*] at 18.

[4] In our 2004 Best Practices Report, we stated that:

> [T]he Forum recommends that a fund board, under the leadership of its independent directors, not permit the fund's adviser to participate in soft dollar arrangements in trades for the fund. Ideally, this prohibition regarding soft dollar arrangements should extend to both formal and informal soft dollar arrangements and to both proprietary and third-party research."

Best Practices at 19; *see also* Letter from Allan Mostoff, President, Mutual Fund Directors Forum to Jonathan Katz, Secretary, United States Securities and Exchange Commission (Nov. 25, 1995) (commenting on proposals to narrow the definition of "research" and reiterating the need for fundamental reform of the regulatory approach to soft dollars). The nature and extent of the conflicts inherent in soft dollar arrangements has not changed since 2004, and we therefore continue to believe that eliminating soft dollar arrangements would benefit fund shareholders.

inherent in protecting against the conflicts posed by soft dollars, the Commission should seek ultimately to eliminate their use.[5]

We recognize, however, that at least in the short run, soft dollars are not likely to be eliminated and that many management companies will continue to use soft dollars as part of advising their funds. We therefore commend the Commission for undertaking to provide additional guidance to the many fund directors who must oversee soft dollars as part of their day-to-day to duties. If soft dollars are not to be eliminated, the Commission must take all the steps necessary to ensure that directors can effectively manage the conflicts posed by soft dollars.

We find much that is positive in the Commission's Proposed Guidance. In particular:

- The Proposed Guidance reaffirms the central role directors play in overseeing soft dollars. In the absence of independent oversight by fund directors, there is no way to address the conflicts posed by soft dollar usage.

- The Proposed Guidance makes abundantly clear that directors have the authority to direct how their fund advisers use soft dollars.

- The Proposed Guidance recognizes that directors have broad authority to ask for and obtain from the fund's adviser information about soft dollar usage. Without these powers, directors would be unable to meet their fiduciary obligation to understand and manage the conflicts posed by their funds' use of soft dollars.

- The Proposed Guidance also states that directors' oversight of soft dollars goes beyond merely reviewing trade execution, and extends to the annual 15(c) contract renewal process. Soft dollars are, as the Commission makes clear, often used to pay for research that the adviser would otherwise either generate itself or acquire with its own funds. The Commission thus concludes that soft dollars provide a significant fall-out benefit to advisers that directors should consider when determining whether fees paid to a fund's adviser are appropriate. We agree that directors should consider this important fall-out benefit during the contract renewal process and recommend that the Commission continue to emphasize the importance of this view.

However, we also see significant problems with the Proposed Guidance. We outline our most significant concerns about the Proposed Guidance below:

---

[5] In the past, we have noted that funds and the fund and brokerage industries as a whole may need to find ways to make an effective transition away from soft dollars. *See Best Practices* at 19-21. While his efforts have not borne fruit, we are also pleased that Chairman Cox has recognized the problems posed by soft dollars and has sought to initiate conversations with the Congress to reduce or eliminate the conflict posed by soft dollars. *See, e.g.*, Letter from Christopher Cox, Chairman, United States Securities and Exchange Commission to the Honorable Christopher Dodd, Chairman, Senate Committee on Banking, Housing and Urban Affairs (May 17, 2007) (urging consideration of legislation to repeal section 28(e) of the Exchange Act, the section which permits soft dollars).

- *The Proposed Guidance Fails to Address the Needs of Directors*

The Commission opens its Proposed Guidance by stating that fund directors have sought further guidance from the Commission on how to oversee their funds' soft dollars programs – specifically, the Commission notes that directors have sought guidance on how to "fulfill their responsibilities with respect to overseeing an adviser's satisfaction of its best execution obligations, including … the adviser's use of fund brokerage commissions." We agree that further advice on overseeing the complex conflicts created by a soft dollar program would benefit fund directors and ultimately fund shareholders.

The essence of the Commission's response to this need is a list of 16 suggested questions that it believes advisers should address (or that directors should insist that advisers address) to assist fund directors in their oversight of soft dollar programs. There is nothing fundamentally wrong with these questions. Indeed, in our experience, directors do seek to obtain information of this type with respect to the funds they oversee.

We have a number of concerns with this approach. We know that "one size does not fit all" and we worry that even though they are only suggested questions, they will be deemed to be required and may even form the basis for regulatory reviews. Moreover, almost all directors already understand the conflicts posed by soft dollar programs and what information they need to obtain to understand both the extent of those conflicts and how the adviser is addressing those conflicts. Hence, while the list of questions at the core of the Commission's Proposed Guidance is not inapposite, it will likely add little to the practices of most fund boards.

At the same time, the Commission's Proposed Guidance says virtually nothing about what directors should do with the information they obtain. We are encouraged by this, in that it implicitly assumes that boards can exercise their oversight and best business judgment. The Proposed Guidance would be improved were this more expressly stated. Otherwise, a board that adopts the Commission's approach – and, again, it is our experience that virtually all boards do seek and obtain information similar to what the Commission recommends – will have at its disposal a huge amount of sometimes very detailed information, but may not necessarily have a clear idea of how the Commission is suggesting that it synthesize and act on that information.[6] At the very least, the Commission should clarify that the list of questions is not mandatory, and

---

[6] Viewed differently, in the absence of either an express emphasis on directors' business judgment or the development of an overarching framework, the result will be a lack of clear and consistent guidance from the Commission regarding what directors are expected to do with the information their inquiries produce and how they should balance the risks and potential benefits of soft dollar usage. Arguably, by failing to address these questions, the Commission is missing an opportunity to go beyond restating board practice, and instead help define best practices at a broader and more fundamental level. In the experience of our members, the conflicts posed by soft dollar usage are complicated, and it is not always obvious how directors should determine whether continued use of soft dollars is in the best interests of fund shareholders or whether specific funds are receiving the optimal benefits from the soft dollars that their portfolio trading generates. The Commission could, if it chose, help directors much more by focusing less on detail-oriented questions and instead by beginning to describe, at least in general terms, a framework that would provide real assistance to directors in overseeing soft dollar programs.

emphasize that what is more important is the framework within which the data is considered and the business judgment of the directors.

- *The Proposed Guidance Will Sharply Circumscribe Director Flexibility by Effectively Requiring Them to Address a Fixed List of Factors as Part of their Oversight of Soft Dollars*

All funds and all fund complexes are different. These differences make effectively regulating the industry difficult. The Investment Company Act embodies a unique solution for this problem: by relying heavily on boards of directors charged with protecting the interests of fund shareholders rather than on endlessly detailed regulatory provisions, it enables a regulatory system that is both flexible and responsive. In recent years, the Commission and its staff have reemphasized not just the importance of independent oversight by boards of directors, but the importance of ensuring that they have the tools, authority and flexibility necessary to exercise their best judgment to protect shareholders.

The Proposed Guidance could be interpreted to undercut these goals. Whether the Commission intends the result or not, providing a list of questions that advisers should address and directors should consider virtually guarantees that every board will address each of these questions, regardless of whether a particular question is relevant to the facts and circumstances that the funds they oversee face. Most simply, the mere fact that a question appears in a formal Commission release (even if that release is characterized as guidance rather than as a rulemaking) gives the question considerable prominence. Discussions of this type are ultimately much more useful to directors, and ultimately to fund investors and to the industry, when they appear in less formal formats, such as industry-produced best practice reports or speeches by Commission staff.

The list of questions in the Proposed Guidance is thus likely to become a checklist that directors feel obliged to address[7] irrespective of their relevance. Doing so reduces the flexibility that boards have to devote resources to the issues and factors that they identify as most important and otherwise consumes board resources that could be more usefully employed elsewhere. As we have already suggested above, fund directors and fund shareholders are much better served by the Commission's identification of key areas of conflict that recur in all soft dollar programs and an emphasis on oversight and good business judgment.

- *The Proposed Guidance Potentially Increases the Litigation Risk Faced by Directors*

As discussed above, by listing questions that directors should address as part of their soft dollar oversight, the Commission creates incentives for directors to address each question and factor as if it were part of a checklist. If directors do not proceed in this fashion, they may well

---

[7] This has happened numerous times before. For example, factors that the Commission described as voluntary when it first promulgated rule 12b-1 are now addressed rotely by every fund board, even though there is virtually unanimous agreement that those factors are outdated and are not of assistance to directors who must determine whether a 12b-1 plan is in the best interests of fund shareholders. The factors listed by the court in *Gartenburg* have likewise become the standard factors that directors must address as part of the annual contract renewal process.

face increased litigation and compliance risk. Even if the Commission ultimately emphasizes that the questions it lists are exemplary, not mandatory, the list of questions will undoubtedly become the *de facto* standard by which directors are judged by plaintiffs' lawyers, courts, some regulators, and others in the investment management community – a board that fails to consider each of the questions posed in the proposed guidance is likely to be vulnerable to claims that it is not meeting its fiduciary obligations. Exposing directors to this type of risk in the guise of providing needed guidance is unnecessary and counterproductive.

- *The Proposed Guidance Provides Little Assistance to Directors on the Key Issue of Quantifying the Value Received in Return for Soft Dollars*

The Commission states early in its analysis that soft dollars pose a conflict because they potentially enable a fund adviser to use fund assets "to obtain research and related services they would otherwise have to pay for themselves." The Commission later notes that, in addition to its review of whether their funds should use, or continue to use, soft dollars, directors should also review, as part of the board's yearly review of the adviser's compensation, the "soft dollar benefits that the adviser receives from fund brokerage." This implies that directors must develop a means of at least estimating what value the fund receives in return for its soft dollars, so that they can compare that value to the actual costs that the fund incurs, and more effectively determine whether shareholders are better off when soft dollars are used and whether the fund is fairly compensating the adviser for the services it provides.

Quantification is potentially even more important when directors compare soft dollar programs to other approaches to trade execution. For example, in many cases, directors will easily be able to quantify the costs and benefits of "execution only" brokerage or various forms of brokerage rebates. If directors are to have any sense of how these approaches compare to the potential benefits of a soft dollar program, they need to have some sense of the actual dollar value of that soft dollar program to a fund.

However, in spite of the fundamental role that valuation plays in overseeing soft dollars, the Commission says little about how the board might accomplish the task and how rigorous its process for valuing the benefits should be. The Commission's suggestion that directors obtain information from the fund's adviser regarding whether "the amount of commissions paid [is] reasonable (based upon a good faith determination) in light of the value of the brokerage and research services provided by the broker-dealer" does little more than restate the problem. Should directors place less emphasis on this issue? Should they demand more rigor in valuing the research that is provided in return for soft dollar brokerage? Should directors look to the cost of unbundled research available on a "hard dollar" basis in attempting to understand the value of the research their fund obtains through the use of soft dollars? How should whatever valuation process is employed ultimately be used in evaluating whether funds should continue to use soft dollars? Similarly, how should the value that a fund's adviser obtains from soft dollars be reflected in the contract renewal process?[8] This omission renders the Proposed Guidance incomplete.

[8] In their consideration of soft dollars, particularly the value of these benefits to the adviser, boards should be careful not to confuse cost with value. Boards can more easily quantify the cost of the research through comparisons to increasingly available third party research. However, the cost of research does not

- *The Proposed Guidance Fails to Address Unbundling*

In recent years, there has been continuing discussion of the possibility of unbundling the execution and soft-dollar portions of commissions to permit directors and others to better understand and more effectively monitor soft dollars and the associated questions of best execution. Numerous boards have either considered or are beginning to insist on unbundling, at least in some circumstances, to better oversee how their fund's trades are executed, how their funds use soft dollars, and how the associated conflicts are managed. And yet, the question of unbundling and whether the Commission views it as a feasible method of managing soft dollars, is almost completely ignored in the Proposed Guidance. As with the Commission's failure to address the difficulty of quantifying the value of soft dollars, this failure seriously weakens the Proposed Guidance.

- *The Proposed Guidance Fails to Emphasize and Protect the Business Judgment of Directors*

An independent board is an important and powerful tool for ensuring that mutual funds function in the best interests of their shareholders. In seeking to identify and protect the best interests of fund shareholders on whose behalf they serve, directors should not be bound by checklists and other lists of factors. Rather, directors should be provided with the tools and flexibility necessary to allow them to exercise, in an informed manner, their business judgment. Directors' informed business judgment is fundamental to the success of the regulatory system—it enables directors to respond to unforeseen circumstances in a flexible and efficient manner, to oversee each fund for which they are responsible based on its individual facts, and ultimately to protect each funds' shareholders' interests.

The Commission must, therefore, seek to protect fund directors' exercise of their business judgment. In particular, when an independent board fairly considers an issue, and determines what it believes to be in the best interests of shareholders, its judgment generally should not be disturbed or subject to further question. Put simply, when directors act independently and diligently, their judgment should prevail. This is particularly important in an area like soft dollars, in which the conflicts are significant, the issues that boards face are complex and difficult, and boards' decisions can easily be second-guessed. If the Commission is going to rely on directors to balance and manage the conflicts posed by soft dollars, it must protect their decision-making process. And yet, the Commission's Proposed Guidance says little about the importance of directors' business judgment and the need protect their independently-exercised business judgment. In revising its Guidance, we urge the Commission to address this important issue.

II. **Best Execution**

The Commission's Proposed Guidance also addresses the broader issue of best execution. Consistent with its fiduciary obligations to a fund and its shareholders, a fund's adviser has a

---

necessarily indicate its value. For example, research could have a low cost and high value to the management of the portfolio and vice versa.

duty to seek best execution for its funds' portfolio trades. However, as the Commission recognizes, advisers face conflicts in this area.[9] Directors thus play a critical role in monitoring fund transactions to ensure that funds do, in fact, obtain best execution.[10]

The Commission correctly notes that, in recent years, directors have been able to obtain significantly more data on the execution quality that the funds they oversee are receiving. Simultaneously, the number and type of trading venues in which funds can execute portfolio trades has increased. Monitoring best execution has thus become more complex and more time-consuming, but no less important—the adviser's trading practices and associated execution costs have a significant impact on the ultimate return to investors. As the Proposed Guidance points out, these costs can represent significant amounts over and above a fund's expense ratio. We thus concur with the Commission's emphasis on the importance of director understanding and oversight of trading practices, and agree that continuing Commission guidance in this area is warranted. [11]

As with the Commission's proposed soft dollar guidance, we find much to like in the Commission's proposed guidance on best execution. In particular, we agree that to effectively monitor the quality of execution that a fund is receiving, a board must have full access to relevant information and must ultimately be able to exert control over a fund's and adviser's execution practices. We commend the Commission for recognizing these two key points.

We also agree with the Commission that fund boards need to educate themselves on the wide array of trading venues used by funds. As trading becomes more complex, education of fund directors is increasingly important. Most boards have already taken steps to familiarize themselves with these alternatives, whether through frequent discussions with traders and portfolio managers about how trades are executed, attendance at industry educational events, or through the use of third parties that help directors explore this area. While we do not believe that changes in the brokerage industry necessitate specific changes to a board's oversight of an adviser's procedures, we do acknowledge that directors must have an understanding of the advantages and disadvantages of particular venues to determine if trading is undertaken in the best interests of shareholders.

In spite of these broad areas of agreement, we do have concerns about the structure and level of detail in the Proposed Guidance. Directors are not effective if they are required to

---

9 In contrast with soft dollar transactions, where numerous conflicts exist, the interests of the adviser and shareholders are generally aligned to the extent that both wish to maximize fund performance. Nonetheless, conflicts remain; as the Proposed Guidance points out, conflicts exist when an adviser (i) executes trades through an affiliate; (ii) determines trade allocations across its clients; and (iii) trades securities between clients. See Proposed Guidance at 45649

10 The Forum has emphasized the importance of a directors' role in assuring that fund advisers use brokerage commissions in the best interests of a fund and its shareholders. *See Best Practices* at 11.

11 As former SEC Commissioner Annette Nazareth stated in an address to the Forum's workshop on trading practices and best execution, "Investors are depending on [directors] to obtain satisfactory answers, to require accountability, to ensure fairness and integrity in the conduct of the fund's business and to maximize the value of their investment." (June 7, 2006, Chicago, Illinois)

micromanage an adviser's trading practices. We agree that boards are most effective when they understand how an adviser executes portfolio transactions on behalf of a fund and satisfy themselves that the adviser's trading policies and procedures ensure that their fund's brokerage commissions are used in the best interest of the fund's shareholders.

Although directors have an important role in monitoring fund trading activities, they should not dictate how these trades should take place. Instead, a board's essential focus should be to ensure that an adviser has appropriate policies and procedures in place to monitor how trades should be executed and ensure that those procedures are being followed. We agree with the Commission that directors should receive sufficient information from the adviser to evaluate the policies and procedures. We also believe that a fund's chief compliance officer (CCO) plays a key role in monitoring an adviser's compliance with its policies and procedures. CCOs are in a better position than boards to closely monitor exceptions to existing policies and monitor trading reports to identify cases where fund shareholders may not be receiving best execution.

Our concerns with the portion of the Proposed Guidance addressing the oversight of investment adviser trading practices largely mirror those expressed above with respect to soft dollar transactions. The experience of our members suggests that directors already have detailed discussions with advisers about trading practices on a regular basis. While we agree that the list of factors included in the Proposed Guidance are generally the correct considerations in this area at this time, the Commission's explicit list of considerations nonetheless risks (i) effectively replacing directors' business judgment with a checklist approach; (ii) becoming outdated, particularly in the rapidly evolving brokerage arena; and (iii) increasing litigation risk. This is especially true since trading practices are dynamic and evolving quickly. Slavish adherence to a list of questions may fail to recognize current trading practices.

We are pleased to see that the Proposed Guidance confirms that best execution does not require an adviser to execute transactions at the lowest price, but rather enables it to take both explicit and implicit costs into account. However, we are unconvinced that a complex area that requires the measurement of implicit costs, such as the price impact of placing an order for a trade or the opportunity cost of missing a trade, as well as explicit costs, can be reduced to a list of questions a board should ask an adviser. Additionally, different funds have different needs when executing fund trades.

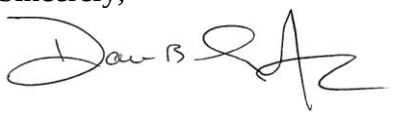
Directors generally have a deep understanding of trading practices used by their funds' adviser. More specifically, they receive substantial information from the adviser on trade execution and, based on this information (as well as their confidence in the controls and procedures governing execution practices) directors must satisfy themselves that the adviser is fulfilling its fiduciary duty. However, given the complexities inherent in assessing whether best execution is being obtained, the directors' analysis is unlikely to result in a clear-cut "yes or no" answer to this question. Hence, what directors could most benefit from is better and more nuanced guidance from the Commission regarding how to weigh any concerns and risks they uncover in the course of their analysis, and, ultimately, how far they should go to satisfy themselves that trades are being conducted in the best interest of fund shareholders.

* * * *

In summary, we appreciate the Commission's recognition of the important role that directors play in overseeing the use of soft dollars and best execution. However, rather than formalistic lists of information that directors should request (which in most cases they already receive), what would be most helpful is practical guidance that would assist them in managing potential conflicts in this area combined with a recognition of the importance of directors' judgment and better protection of that judgment.

Again, the Forum very much appreciates the opportunity to comment on this important proposal. We would be happy to discuss any of the issues raised in this comment letter with you or the Commission's staff at any time.

Sincerely,



David B. Smith, Jr.
Executive Vice President and General Counsel

cc: The Honorable Christopher Cox
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Andrew J. Donohue, Director, Division of Investment Management