Keil Fiduciary Strategies
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September, 2008

Re: Response to request for comment on *SEC Release 34-58264; IA-2763 File No. S7-22-08*

[*Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices*]

Dear SEC:

Per the SEC's request, allow me to offer a few quick thoughts on the current proposal to provide guidance to fund directors on fulfilling their responsibilities with regard to oversight of trading practices. In particular, I would especially like to provide feedback on the issue of soft dollars and bundled commissions.

Upon reading the above release, I was impressed with the comprehensiveness of the topics and issues covered. Others in the industry I have spoken to about the proposed guidance had similar feelings. However, I was struck by the sheer volume of disclosure, questions, and detailed dialogue that must occur between boards and fund advisers when the topic of the use of fund brokerage arises, the conflicts that inherently exist, and the clear potential and/or leeway for many levels of abuse. The related workload that may be reasonably shouldered by a large complex may be a burden on smaller fund groups.

Thinking like a director, what also occurred to me was "how am I supposed to weed through the reams of trading information and adviser policy to glean what may be less than fully above-board, not in the clients' interests, and/or marginal fiduciary behavior?" The answer is, based on the complexity of the current 28(e)-blessed model, that it is no easy task if improprieties can indeed be identified when they exist. Perhaps most problematic, many boards do not know *how* the data should be optimally presented (or can't agree) to enable them to do their jobs effectively. This issue can pervade many board responsibilities.

As a director, I would yen for someone to provide me with a red flag list of trading situations or conditions that warrant investigation and/or further explanation to a board from their funds' adviser. And, I might also find a frequently asked (probing) questions list useful. A simple 'dump' of information and boilerplate policy would only provide subtle clues to a very trained, expert eye (not inclusive of many directors). Many directors are neither forensic accountants, nor do they wish to be! Based on the SEC's prior experience with enforcement actions, a solid idea of likely abuse areas certainly exists.

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Assuming the SEC is neither seriously considering significant revisions or repeal of 28(e) nor supporting unbundling, I submit the following observations, suggestions, and considerations of the below topics regarding the proposal. *[Please note that many of these items may already be thoroughly examined and considered during annual compliance reviews at some fund complexes.]*

- Many *implicit* trading costs are arguably unquantifiable and can only be taken into account by directors as intangibles that only seek to cloud the issues, may serve to unintentionally justify trading premia, and promote inaction; yet, some guidance in this area would be useful, e.g., what should be disclosed, what can be quantified, how the advisor seeks to mitigate 'hidden costs' etc.

- Some reference to ECN's specifically and their justified use may be desirable, e.g., the extent to which ECNs are used, why more traditional and typical more costly venues are use, the criteria for when ECNs are utilized etc.

- Would it not be desirable to state that directors should start with the premise that at least some of the least expensive trading avenues should be used and the 'burden of proof' for using more pricey alternatives should be on the adviser?

- Consider urging directors to require broker performance reports semi-annually or quarterly

- Clarify that brokerage commissions paid using soft or hard dollars includes all payments to affiliated and unaffiliated entities

- Urge directors to request "execution-only trade" per share data and industry benchmark data, where available

- Expand on the concept of sub-advisor oversight to include a 'flow-through' of SEC requirements from the advisor to the sub-advisor, e.g., require the advisor to request of the sub-advisor all the policy information, data etc. that is expected of them by the board

- Consider recommending that advisers provide a formal quantitative analysis of "best execution" (*avoid boilerplate*) including all the factors commonly known to impact trade quality, e.g., speed of transaction, price, competitive spreads, appropriate use of ECNs, segmenting of trades to lower market impact etc. (smaller complex boards can use their judgment to lower the information expectations and avoid issues that may befit the likes of Fidelity, but not little fund groups)

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- On the issue of "related matters" that the board may wish to discuss with their adviser, specifically mention the issue of handling bad trades, reversals, cost burden etc.

- Consider providing directors with license to request of their adviser a list of each product and service received through the placement of soft dollars and how this trading practice specifically benefits the fund segment – the board can then decide if tertiary benefits are incidental or potentially an avoidance of cost

- In several segments of the guidance, clearly emphasize the application of directors' business judgment when assessing trade execution quality, and soft dollar payment levels and appropriateness

- The SEC may wish to actually define what a correctly structured commission recapture arrangement and a sanctioned expense reimbursement arrangement look like for clarity

- The value of research services are arguable elusive when they are bundled – suggest that boards request a dollar value be placed on the two components of a bundle (execution, research), so comparisons can be made and value can be assessed, to the extent feasible

- With regard to the "good faith determination under 28(e)" I think it may be wise to also have the adviser provide an actual list of how each product and service attained through soft dollars are leveraged in other areas of the investment adviser's firm (fall-out benefits) – shareholder value, or little thereof, and significant other uses should then surely be more transparent (see point 4 items above)

- Consideration and/or support should also be given to the concept of soft dollar quotas (% of trades) based on complex size, research and "intellectual property" needs, and with the directors applying their business judgment to proportions and 'need'

- To the SEC's question about "examples of effective board practices" with regard to 28(e), I very frankly think that most boards generally ensure that the paper trail (documentation) of data and policy is in place and are hamstrung (or appropriately resist micromanagement) to extensively and highly scrutinize and validate items such as security research value, other service values, exactly how the research is used etc.

- Pulling the soft dollar question into the 15(c) realm, surely it is problematic at best to expect boards to take into consideration the dollar value of products, research etc. that are procured through soft dollar payments when looking at advisory fee schedules and revenues. I would

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hazard an educated guess that most boards: 1) assume that most other advisers also use soft dollars so the playing field is essentially leveled; 2) do not 'discount' fees in any way for vigorous use of soft dollars; 3) do not truly consider soft dollars in a concrete fashion as a "fall-out benefit;" and 4) assume that they cannot truly uncover the extent to which research impacts investment decisions and thus, creates value for soft dollars 'directed;' boards willingly accept payments and some assumed performance value as a normal part of the advisory business

- In line with the OCIE, I would concur that soft dollar practices disclosure requirements be strengthened in an attempt to eliminate the dreaded boilerplate from most fund filings; one can point to the revised '15(c) factors considered' (contract renewal rationale) disclosure changes that were put in place several years ago to see how very specific requirements allow for precious little wiggle room and thus, creates a better chance for value-added annual report or prospectus verbiage

- And, yes, I would require an adviser put into print (N1-A) many of the items that must be furnished to the board, e.g., why soft dollars are used, when soft dollars are preferred over hard dollars, how the funds benefit etc.

- Finally and assuming that brokerage costs take a large chunk out of most retail investment accounts, I like the idea of customized brokerage data for each client to ensure that costs are transparent; why should brokerage be exempt from sanitizing sunlight??

- One last perhaps fringe consideration: take the arguably **bold** step and remind boards that they can, within their legal rights, ban some or all soft dollar payments by their advisers (funds) if they see fit and applying their business judgment; or, actually encourage elimination of soft dollar payments in the cases where lack of outside investment research would not operationally cripple

Having offered these thoughts and considerations on the proposal, my preferred suggestion for the best solution to board oversight of brokerage is simple and not new. The SEC should support the notion and suggest to Congress that brokerage and research be separated (unbundled), in essence wiping 28(e) off the map. I heartily concur with the several large fund shops that have already taken this route that unbundling is straightforward, more transparent, and the best course for clients. Yet, the leading complexes have the luxury of this course of action given their brokerage volume, market clout, and staff and financial resources. I admittedly struggle with the benefits that small fund shops get from bundled trades and the third-party research value they derive. I am not in favor of reducing competition in the business via 28(e) repeal and regrettably do not have an iron-clad solution to this dilemma. Perhaps applying the exemption

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process, quotas by complex (or firm) asset size, or onerous requirements prior to placing soft dollar trades might do the trick.

By separating brokerage from research (intellectual property), a board and shareholders are surely advantaged in the following ways, if not others:

- A much higher level of simplicity and clarity of benefits, cost, and shareholder value
- A likely elevated focus on security transaction costs alone
- The ability to benchmark gross brokerage costs (to the extent valuable)
- Clearly put the onus of research value in the adviser's court
- By removing the 'friction' of research, allow the free markets to set brokerage costs
- Sidestep the many unavoidable conflicts of interest that exist in the soft dollar arena
- The ability to consider reinstating brokerage costs per share disclosure in the fee table
- Avoid the plethora of soft dollar disclosures and discussions that must now pass/take place between the adviser and the board
- Finally, the ability for boards – in my opinion – to leverage their time in more valuable ways

I trust at least some of my suggestions and observations strike a few chords and prove to be useful. Please do not hesitate to contact me if you wish to discuss in greater detail any of the aforementioned.

Respectfully submitted,

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