MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

November 25, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: Commission Guidance Regarding Client Commission Practices
Under Section 28(e) of the Securities Exchange Act
File No. S7-09-05

Dear Mr. Katz:

The Mutual Fund Directors Forum ("the Forum")[1] appreciates the opportunity to comment on the proposed interpretation by the Securities and Exchange Commission ("Commission" or "SEC") respecting client commission practices under Section 28(e) of the Securities Exchange Act of 1934, as amended ("Section 28(e)").[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

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1 The Forum's current membership includes four hundred eighty independent directors, representing fifty-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 Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act, Exchange Act Rel. No. 52635 (Oct. 19, 2005) [70 FR 61700 (Oct. 25, 2005)] ("Release"). The Release indicates that the Commission's use of the term "client commission" practices or arrangements to refer to practices under Section 28(e) is intended to "avoid confusion that may arise over usage of the phrase 'soft dollars.'" Release at n.2. The term "soft dollars" has been used to refer to these arrangements for many years, and substituting the term "client commission" arrangements at this time is unlikely to achieve the Commission's stated purpose.

opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors today and serves as an independent vehicle through which Forum members can express their views on matters of concern.

Mutual Fund Directors Forum Recommended Best Practices

In July 2004, in response to a request from then SEC Chairman William H. Donaldson, the Forum issued a Report of Recommended Best Practices and Practical Guidance for Mutual Fund Directors ("Report").[3] Chairman Donaldson had asked that the Forum develop best practices and guidance in a number of areas, including client commission practices under Section 28(e), where director oversight and decision-making is critical for the protection of fund shareholders.[4] In the Report, the Forum recommended that a fund board should not "permit the fund's adviser to participate in soft dollar[5] arrangements in trades for the fund."[6]

The Forum's recommendations regarding soft dollar arrangements were, like all of its recommendations respecting transactions in portfolio securities for investment companies, guided by the following "fundamental principles":

- **Brokerage commissions are an asset of the Fund.** When a fund's adviser decides that the fund should buy or sell a portfolio security, the adviser places a trade for the transaction with a broker-dealer, and the fund pays that broker-dealer a commission for effecting the transaction. The brokerage commission

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3 The Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004), available at www.mfdf.com.

4 Letter from Chairman William H. Donaldson, Securities and Exchange Commission, to David S. Ruder and Allan S. Mostoff (Nov. 17, 2003). *See* Report at 40.

5 The Forum defined "soft dollars" as arrangements under which, in addition to execution of securities transactions, proprietary or third party research services or products are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer. Report at 17.

6 Report at 19. The Forum's Recommended Best Practice did not reflect the unanimous view of Forum members. In the Report, the Forum acknowledged the prevalence of soft dollar practices and that implementation of its recommended best practice would likely have an economic effect on fund advisers and on trading practices. Report at 19. It also should be noted that the broker-dealer exception from the definition of "investment adviser" in the Investment Advisers Act of 1940, as amended ("Advisers Act"), is limited to brokers and dealers that perform advisory services "solely incidental" to the conduct of their business as a broker or dealer and without "special compensation" for such services. Section 202(a)(11) of the Advisers Act [15 USCS §80b-2 (2005)]. Accordingly, receipt of non-commission payments for research may preclude a broker-dealer from relying on this exception.

The Forum also recognized that although some fund boards may embrace the recommended best practice, and along with their advisers, eschew soft dollar arrangements, others may not, which could place a fund's adviser at a competitive disadvantage to its peers. Report at 20. The Forum noted that the reform contemplated by its recommended best practice would be more equitably instituted if achieved through a change in applicable law, after study of the economic impact and an opportunity for interested parties to comment. Report at n.54.

paid by the fund is an asset of the fund and should be used in a fashion that is in the interests of the fund and its shareholders.[7]

- **Best execution should govern.** Best execution should govern the allocation of trades in portfolio securities to broker-dealers.[8]
- **Transparency is an important objective.** Clear identification of costs and benefits, or transparency of fund transactions, is basic to understanding the economics of transactions between funds and broker-dealers. Transparency better enables fund boards and, in appropriate circumstances, shareholders, to evaluate and assess costs of securities transactions and their impact on fund performance. Transparency can facilitate comparisons of the costs of securities trades and analysis of a fund's operating expenses, as well as its investment adviser's revenues and expenses in managing the fund.[9]

As the Forum stated in its Report, when an adviser receives a benefit in the form of a research service or product from a transaction for the fund, the arrangement gives rise to a potential conflict of interest between the adviser and the fund.[10] The Report noted that soft dollar arrangements raise the following questions:

- Whether a transaction has been allocated to a broker-dealer on the basis of the research provided to the adviser rather than the quality of the execution provided to the fund;[11]
- Whether a lower commission could have been paid for a transaction or whether the fund could have recaptured a portion of the brokerage commissions if the adviser had not received research;[12]

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7 Report at 11. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Inv. Co. Act Rel. No. 26591 (Sept. 2, 2004) [69 FR 547128 (Sept. 9, 2004)] at n.8 ("Because it is an asset of the fund, fund brokerage must be used for the fund's benefit."); Prohibition on the Use of Brokerage to Finance Distribution, Investment Company Act Release No. 26356 (Feb. 24, 2004) [69 FR 9726 (Mar. 1, 2004)] at n.17 and accompanying text ("Fund brokerage is an asset of the fund, and therefore must be used for the fund's benefit.")

8 Report at 12. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Inv. Co. Act Rel. 26591, *supra* note 7, at n.16 ("As with all other portfolio securities transactions . . . the adviser has a duty to seek best execution. The adviser must see that . . . portfolio securities transactions are executed 'in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances." (citation omitted)); Securities, Brokerage and Research Services, Exchange Act Release No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1986)] ("[T]he Commission emphasizes that money managers, particularly investment advisers registered under the Advisers Act, have important fiduciary and disclosure obligations concerning soft dollar practices, as well as a duty to obtain best execution of their client's transactions.")

9 Report at 12.

10 Report at 18.

11 *Id. See* Soft Dollars and Other Brokerage Arrangements, Thomas P. Lemke and Gerald T. Lins (2005 ed.) at 1-7.

12 Report at 18.

- Whether other funds in the complex or other clients of the adviser are benefiting from the research an adviser receives in connection with a trade for the fund;[13]
- Whether the value of the research provided by a broker-dealer is reasonable in relation to the commission paid;[14]
- Whether the need for research has motivated the adviser to place trades that it might not otherwise place;[15] and
- Whether the adviser should reimburse the fund for the value of the research.[16]

Proposed Interpretation of Section 28(e)

In 1975, Congress enacted Section 28(e) with the specific intent to provide a safe harbor for money managers engaging in soft dollar arrangements designed to provide "brokerage and research services" to their clients. The Forum understands, therefore, that notwithstanding the many issues raised by the issue of soft dollars, the Commission cannot by rule prohibit all such arrangements. Accordingly, the Forum supports the Commission's initiative to restrict the scope of the statutory safe harbor with the objective of assuring that soft dollar arrangements are, at least, limited to those of direct benefit to advisory clients, *i.e.,* appropriate "brokerage and research services".

The proposed guidance, although not the sweeping reform necessary to address the Forum's fundamental concerns about soft dollar arrangements, will improve the status quo by more clearly defining the goods and services a fund adviser may acquire with the fund's brokerage commissions. We view the proposal as a first and useful step in addressing the larger issues presented by soft dollar arrangements. To enable effective monitoring of such arrangements, publication of the guidance should be followed by prompt Commission action to clarify the disclosure obligations of money managers who utilize soft dollar arrangements in executing brokerage transactions for their clients.

It is beyond question that an investment adviser's use of soft dollar arrangements to pay for items that should be included in the adviser's overhead, such as rent or utilities, is not an appropriate use of fund resources.[17] In fact, as the Forum noted in its Report,

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13 Report at 18.

14 *Id.*

15 *Id.*

16 *Id.*

17 *See* Securities; Brokerage and Research Services, Exchange Act Rel. No. 23170, *supra* note 8, at n.10 ([O]bvious overhead expenses such as office space, typewriters, furniture and clerical assistance would not constitute research [for purposes of the Section 28(a) safe harbor].") The 1998 report by the Office of Compliance Inspections and Examinations contained numerous examples of abusive soft dollar practices by investment advisers. *See* Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (September 22, 1998).

even soft dollar arrangements that are limited to research enable the adviser to avoid expenditures that it might otherwise make. Such arrangements produce savings to the investment adviser that may not be transparent to the fund's independent directors when they examine the adviser's income and expenses in connection with their annual review of the fund's investment advisory contract.[18] Additionally, as fund independent directors review the allocation of brokerage transactions, they may find it difficult to evaluate the benefit an adviser obtains from a soft dollar arrangement and the actual allocation of brokerage transactions. The problem is necessarily magnified when investment advisers attempt to rely on the Section 28(e) safe harbor to use fund commissions to defray overhead costs.

The Forum therefore supports the Commission's effort to clarify the safe harbor and limit the circumstances in which fund commissions can be used to the benefit of advisers.

Directed brokerage arrangements distinguished from soft dollar arrangements

The Forum generally supports the Commission's efforts to distinguish between "directed brokerage arrangements"[19] that directly benefit a fund and "client commission"[20] practices or arrangements that raise adviser conflict of interest concerns. It is important, however, that any final interpretive release clarify that directed brokerage arrangements are not problematic merely because they are not within the safe harbor of Section 28(e).[21]

The Release recognizes that "unlike client commission arrangements that raise conflict of interest concerns addressed by Section 28(e), directed brokerage arrangements do not raise [conflict of interest concerns] because they typically involve the use of a fund's commission dollars to obtain services that directly and exclusively benefit the fund."[22] The Forum, in its Report, referred to such arrangements as "expense reducing

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18 Report at 18.

19 The Release describes "directed brokerage transactions" as transactions in which a portion of the commission is recaptured for the client or used to pay client expenses or for administrative services. Release at n.20.

20 The Release defines "client commission" practices or arrangements as practices under Section 28(e). Release at n.2, discussed at note 2, *supra*.

21 The Release characterizes directed brokerage transactions as being outside of the safe harbor of Section 28(e), because the "safe harbor is available only to persons who are exercising investment discretion." Release at n.20. Both directed brokerage and "client commission" practices are distinguishable from the use of fund brokerage to compensate broker-dealers for selling fund shares – a practice banned by the Commission in 2004, when it amended Rule 12b-1 under the Investment Company Act to prohibit funds from compensating a broker-dealer for promoting or selling fund shares by directing brokerage transactions to that broker. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, Investment Company Act Release No. 26591 *supra* note 7.

22 Release at n.20.

directed brokerage" and noted that such arrangements can be beneficial to a fund because it can lower the cost of a transaction in a portfolio security or can lower the fund's operating expenses.[23] The Forum agrees that such brokerage arrangements do not give rise to an apparent conflict of interest between the fund and its management.[24]

Notwithstanding the Commission's statement noted above, the Forum is concerned by the potential ambiguity of the Commission's juxtaposition of its analysis with the statement that "[c]onduct not protected by Section 28(e) may constitute a breach of fiduciary duty as well as a violation of federal securities laws, particularly, the Investment Advisers Act of 1940 and the Investment Company Act of 1940, and the Employee Retirement Income Security Act of 1974." (citations omitted)[25]

Although a person whose conduct falls within the Section 28(e) safe harbor is protected by that safe harbor from being deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law, the converse of that statement is not true – clearly, conduct that is not otherwise unlawful or a breach of a fiduciary duty does not become so simply because it lies outside of the Section 28(e) safe harbor.[26]

The Forum therefore respectfully requests that the Commission make clear in any final interpretive release that fund directors, and other persons who may have fiduciary duties respecting the use of fund brokerage,[27] but for whom the safe harbor is arguably unavailable because they are "not exercising investment discretion," should not be

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23 Report at 16.

24 Report at 16. These arrangements do raise the question of whether, apart from the benefit of the expense reduction, the fund also receives best execution on such trades. The Forum has stated that fund boards should review the quality of the execution a fund receives on transactions in its portfolio securities that are placed with broker-dealers in these arrangements. Report at 17. The directors should compare the quality of the execution on these trades to the quality of other trades, with a view to assuring that the fund is receiving best execution. *Id.*

The Commission's recent rule amendments concerning compliance programs of investment companies and investment advisers emphasized the adviser's obligation to provide information to fund boards about trading practices. In this regard, Advisers Act Rule 206(4)-7 requires investment advisers to adopt and implement written compliance policies and procedures that address, among other things, trading practices, including procedures by which the adviser satisfies its best execution obligation, uses client brokerage to obtain research and other services, and allocates aggregated trades among clients. *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714, 74716 ((Dec. 24, 2003)]. Investment Company Act Rule 38a-1 requires fund boards to approve the compliance policies and procedures of the fund and each of its service providers, including the fund's investment adviser. Rule 38a-1(a)(3) further requires fund chief compliance officers to review no less frequently than annually the adequacy of the adviser's compliance policies and procedures and the effectiveness of their implementation.

25 Release at 9.

26 *See* Securities; Brokerage and Research Services, Exchange Act Rel. No. 23170, *supra* note 8 ("Section 28(e) ... cannot by its terms be violated. Thus, the fact that sponsor directed brokerage transactions are outside its protections does not necessarily mean that such transactions are illegal.")

27 The Release explicitly states that "directors of an investment company have a continuing fiduciary duty to oversee the company's brokerage practices." Release at n.5.

presumed to be in violation of the federal securities laws or ERISA – or to have breached their fiduciary duty to the fund – simply because the safe harbor is unavailable to them. In particular, the Forum suggests that the Commission make clear in the final interpretive release that directed brokerage arrangements not within the ambit of the Section 28(e) safe harbor, but which do not involve conflicts of interest concerns, are not per se violations of law.[28]

Disclosure and recordkeeping regarding client commission arrangements

The Release takes note of the fiduciary obligations of investment company directors to oversee the fund's brokerage practices, and states that the directors have an additional obligation in connection with their review of the fund's investment advisory contract to review the adviser's compensation, including any "soft dollar" benefits the adviser may receive from fund brokerage.[29] The Forum agrees and has, in this connection, encouraged fund directors to seek from the adviser information on any "ancillary benefits" the adviser may realize from its association with the fund, including benefits such as research services the adviser receives as a result of brokerage generated by the fund.[30] The Forum has further recommended that directors request that the adviser quantify soft dollar benefits in the reports submitted to the board in connection with the annual renewal of the investment advisory agreements.[31]

The Forum has also urged fund boards that permit their advisers to use soft dollar arrangements to insist that the fund receive best execution on "soft dollar" trades, and has stated that independent directors should review the quality of the execution their fund receives on transactions in which its adviser receives research or products and compare the quality of the execution of "soft dollar" trades to the execution quality of other trades (without giving a value to the research provided), with a view to assessing whether the fund is receiving best execution on its trades.[32]

As indicated above, the Forum views the Commission's proposal as a useful step in addressing the larger issues presented by soft dollar arrangements. In the Release, the Commission indicated that it is considering whether, at a later time, to propose

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28 *See* Payment for Investment Company Services with Brokerage Commissions, Investment Company Act Rel. No. 21221 (Jul. 26, 1995) [60 FR 38918 (Jul. 28, 1995)] at n.1-2 ("Brokerage/service arrangements are structurally similar to the more common research soft dollar arrangements under which an investment adviser uses client commission dollars to obtain research services. In a research soft dollar arrangement, however, the receipt of a benefit by an adviser through the use of its clients' commission dollars raises conflict of interest concerns addressed by the safe harbor provision of section 28(e) of the Securities Exchange Act of 1934. These concerns generally are not raised by brokerage/service arrangements, which typically involve use of a fund's commission dollars to obtain services that directly and exclusively benefit the fund.")

29 Release at n.5.

30 Report at n.95 and accompanying text.

31 Report at 22.

32 Report at 21.

requirements for disclosure and recordkeeping of client commission arrangements.[33] In light of the fact that under the Commission's current proposal, soft dollar arrangements would continue to be permitted, the Forum believes that it is imperative that the Commission also require fund advisers to make clear and full disclosure to fund directors of all "brokerage and research services," including their value,[34] acquired by the advisers through soft dollar arrangements.[35] This disclosure is essential to enable fund directors effectively to satisfy their oversight responsibilities. The Forum therefore urges the Commission to proceed as expeditiously as possible to require fund investment advisers to provide fund directors with all information and reports necessary for the directors to evaluate soft dollar arrangements involving their fund's brokerage commissions.

Request for comment

The Commission has requested comment on whether the proposed interpretation offers sufficient guidance with respect to the types of "advice," "analyses," and "reports" that are eligible as "research services" within the Section 28(e) safe harbor. We recognize it is not easy always to delineate clearly between "research" and other goods and services, as evidenced by the Commission's difficulty in analyzing mass marketed business publications and the hardware used to deliver them. Nonetheless, in providing guidance, we urge the Commission to narrow the definition of "research services" as much as practicable, consistent with the statute. Clear guidance on the definition of

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33 Release at n.7. *See also* Release at n.72 ("In addition to concerns over the scope of the safe harbor under current market conditions, the Commission recognizes that improvements may be necessary in disclosure and documentation of client commission practices.")

34 With respect to soft dollar arrangements, we recognize that there are strongly held, divergent views among industry participants on the issue of how investment advisers are to value separately research that is bundled with other services provided by a broker-dealer, and in particular whether broker-dealers can and should be required to provide investment advisers with estimates that disaggregate the commissions received for research from those received for other services. *See* Report of the Mutual Fund Task Force on Soft Dollars and Portfolio Transaction Costs, Nov. 11, 2004 at 8-11.

Further, we note that, in the context of the Commission's recent rulemaking prohibiting the practice of directing brokerage as compensation for sales, the Commission determined, in light of the "practical limitations on the ability of fund directors to actively monitor and evaluate the motivations behind the selection of brokers to effect portfolio securities transactions," to ban the practice rather than adopt an approach by which fund boards receive periodic reports about brokerage allocation. *See* Prohibition on the Use of Brokerage Commissions to Finance Distribution, *supra* note 7, at n.17 and accompanying text.

Because Section 28(e) precludes the Commission from taking the same approach with respect to the use of client commissions to pay for research, the Forum believes that the Commission has no practical choice other than to confront and resolve the difficult issues involved in the valuation of research obtained with client commissions. Absent this information, it is extraordinarily difficult for fund independent directors to fulfill the Commission's expectations with respect to their oversight of these arrangements.

35 The Commission may also wish to clarify the effect of any such disclosure on the issue of whether a broker-dealer is receiving "special compensation" for providing investment advice. *See* discussion at note 6 *supra.*

"research services" will allow directors to more effectively monitor soft dollar arrangements.[36]

The Commission also has asked commentators to address whether the proposed interpretation has accurately identified the industry practices for which guidance would be most useful, and to offer comments on any significant issues arising under Section 28(e) that the Release has not addressed. We urge the Commission and its staff, when considering all issues surrounding Section 28(e), to remain mindful that it is a ***safe harbor***, providing protection from liability for conduct that would otherwise be unlawful or a breach of fiduciary duty. For this reason, it should be narrowly construed, and where there is ambiguity, presumed to be unavailable.

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We appreciate this opportunity to comment on the proposed Section 28(e) interpretive release and would be pleased to discuss any of the comments made in this letter.

Respectfully submitted,

Allan S. Mostoff
President
The Mutual Fund Directors Forum

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[36] Further interpretive guidance may be appropriate – or even necessary – in the future as industry practices continue to evolve.