SEC Proposes Guidance on the Role of a Fund Board in Overseeing an Adviser's Portfolio Trading Practices

On July 30, 2008, the SEC proposed guidance to registered investment company ("fund") boards intended to assist them in fulfilling their fiduciary responsibilities relating to the oversight of the trading of fund portfolio securities by a fund investment adviser ("adviser").[1] The proposed guidance provides, generally, that a fund board should ensure that it has sufficient familiarity with an adviser's portfolio trading practices to satisfy itself that the adviser is acting in the best interests of the fund. The proposed guidance suggests several examples of matters about which a board should inquire and data a board should request. Although the proposed guidance purports not to impose any new or additional requirements for fund boards, it raises several potential issues.

- **The release often adopts a prescriptive tone.** A substantial portion of the proposed guidance addresses inquiries that a board *should* make, matters with respect to which a board *should* request information, data a board *should* review and matters regarding which fund board members *should* become and/or remain educated. Other portions of the proposed guidance relate to, for example, matters a fund board *may* discuss. While the SEC stated in the release that it was "proposing guidance for fund directors to *consider* in performing their responsibilities [emphasis added]," other statements in the release seem to confuse this stated intent.[2] We anticipate that commenters may inquire regarding the degree to which SEC examination staff will rely on the guidance when examining fund complexes.
- **The scope of the inquiries the SEC believes fund boards should make and the information the SEC believes that fund boards should review suggests a substantial time commitment by fund boards.** An adviser's portfolio trading practices, though clearly important to a fund's interests, are but one of a number of issues that a board must address in a finite amount of time at its regular board and/or committee meetings. The proposed guidance sets forth a page and a half of possible inquiries regarding an adviser's best execution obligations, a page and a half of possible conflicts of interest to consider when evaluating an adviser's use of fund brokerage commissions and two pages of matters as to which a fund board *should* request that an adviser inform it. We anticipate that commenters may inquire whether such lists are meant to be prescriptive for fund boards and, if so, whether a thorough analysis of all such matters and data is necessary or feasible. Ultimately, it should be the case that fund boards are entitled to exercise their business judgment as to the appropriate scope and depth of their oversight activities in this regard.
- **The proposed guidance highlights a possible conflict between the interests of funds and the latitude afforded advisers by the Section 28(e) safe harbor.** While Section 28(e) provides explicitly that an adviser may consider the value of brokerage and research services received in light of its overall responsibilities to all of its discretionary client accounts, the proposed guidance provides that a fund board should evaluate an adviser's use of fund brokerage commissions to purchase research and services in order to determine whether such use is in the best interests of the fund. The proposed guidance states that if a fund board determines that the fund's brokerage commissions could be used differently so as to provide greater benefits to the fund, the fund board should direct the adviser accordingly. Moreover, the proposed guidance provides that a fund board should require an adviser to explain whether the brokerage and research services received by the adviser are "inappropriately benefiting another of the adviser's clients at the fund's expense." Given the apparent latitude provided by

Section 28(e), it is unclear what the SEC would consider an "inappropriate" benefit. We anticipate that commenters may request clarification of this issue.

- **The proposed guidance presumes the ability and competence of a fund board to direct an adviser's actions relating to portfolio trading activities.** For example, the proposed guidance assumes that a fund board may unilaterally "prohibit or limit" an adviser's use of fund brokerage commissions. Although fund boards presumably have plenary power regarding the management of fund assets, as a practical matter, within the context of an established fund business in which there is a long course of dealing between the funds and the adviser that is based in part on the adviser's existing brokerage and soft dollar practices, the ability of a board to exercise that power may be somewhat constrained. The SEC suggests that fund boards have indirect power over the adviser's brokerage practices through negotiation in the context of advisory contract renewals; the proposed guidance states that a fund board's consideration of an adviser's compensation should consider soft dollar benefits that the adviser receives from fund brokerage. However, a negotiation is just that, and an adviser that is prohibited from using fund brokerage commissions may demand a higher advisory fee in lieu of such use. In addition, if the fund is a relatively small client of the adviser (for example, in a fund complex that employs many different sub-advisers), the practical ability of the fund board to direct the adviser's brokerage practices may be quite limited.
- **Finally, the extent to which boards representing multiple funds in a fund complex must evaluate the matters discussed in the proposed guidance on a fund-by-fund basis is unclear.** For example, the proposed guidance provides that a fund board should require an adviser to show how fund brokerage commissions and the adviser's use of soft dollar commissions were allocated when considering the adviser's compensation. Many fund boards review such commissions in the aggregate on a complex-wide basis, and it is unclear whether it is feasible to identify specifically the soft dollar benefits attributable to a particular fund in a complex. Similarly, it is unclear whether an adviser could determine that the brokerage commissions of a particular fund in a complex were used to purchase research that primarily or solely benefited another adviser client. We anticipate that commenters may request clarification of the scope of this review for fund boards overseeing large fund complexes.

The SEC solicited general comment on the proposed guidance, and also specific comment on whether: (i) further disclosure to fund investors of information the SEC suggests fund boards consider would be helpful; (ii) any specific disclosure should be mandated to better assist investors in making informed investment decisions; and (iii) the public dissemination of particular information regarding an adviser's portfolio trading practices would have an adverse effect on the adviser's relationship with broker-dealers who execute fund transactions. Comments on the proposed guidance must be received by the SEC on or before October 1, 2008.

Contact Information

If you have any questions, please contact your regular Ropes & Gray attorney.

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1. The SEC also solicited comments regarding (a) whether required disclosure for investment advisers with respect to trading practices should be broadened and (b) whether investment advisers should be required to provide clients with customized information about how their individual brokerage is being used.
2. For example, the SEC stated the following: "Today we are proposing guidance with respect to information a fund board should request that an investment adviser provide to enable fund directors to determine that the adviser is fulfilling its fiduciary obligations to the fund and using the fund's assets in the best interest of the fund. Our proposed guidance also is intended to assist the board in directing the adviser as to how fund assets should be used." [Emphasis added.]