

SEC Proposal Outlines Duties of Mutual Fund Boards in Monitoring Best Execution

The Securities and Exchange Commission has proposed guidance to investment company directors for fulfilling their oversight and monitoring responsibilities with respect to a fund adviser's best execution obligations and the conflicts that arise with the use of soft dollar arrangements (the "Guidance"). The Guidance would not impose any new requirements on fund directors, but rather seeks to provide directors with a flexible framework to evaluate the adviser's best execution obligations.

In reaction to the Guidance, investment company boards and fund advisers should expect that annual Section 15(c) questionnaires sent to fund advisers will contain more detailed requests for information concerning fund portfolio transactions and that consideration of such information will expand board deliberations. More broadly, the Guidance reveals a detailed view of the SEC's analysis of any adviser's best execution obligations. Investment advisers may wish to consider the Guidance as a blueprint for crafting policies, procedures and disclosures concerning best execution obligations, including the use of soft dollars.

Board Oversight of Best Execution

Investment advisers have a fiduciary duty to seek best execution of client securities transactions. Rule 38a-1 under the Investment Company Act of 1940 (the "1940 Act") requires that the adviser's board-approved policies and procedures address, among other things, best execution. The Guidance suggests that fund directors evaluate the adviser's best execution policies and procedures on the basis of the following information:

- Identification of broker-dealers used to effectuate trading;
- Commission rates or spreads paid;
- Total commissions and value of securities executed that are allocated to each broker-dealer; and
- Portfolio turnover rates.

The fund's board should also discuss with the adviser how the adviser:

- Makes trading decisions and selects its broker-dealers;
- Determines best execution and evaluates execution quality (including how best execution may be affected by the use of alternative trading systems);
- Negotiates and evaluates commission rates and how transaction costs are measured generally;
- Evaluates and compares the execution of "execution only" trades;
- Evaluates the performance of traders and broker-dealers;
- Oversees and monitors sub-adviser activities;
- Conducts portfolio transactions with affiliates;
- Trades fixed income securities;
- Evaluates trade execution quality with respect to fixed income and other instruments traded on a principal basis; and
- Conducts and monitors international trades.

With this information, fund directors should assess whether the adviser’s trading practices are being conducted in the best interests of the fund. If not, fund directors should direct the adviser accordingly. The Guidance also highlights the fund board’s need to remain current with the rapid development and increase in alternative trading systems (e.g., dark pool trading).

Board Oversight of Soft Dollars

Since fund brokerage commissions are fund assets, investment advisers have a conflict of interest when such commissions (“soft dollars”) are used to obtain brokerage and research services that they would otherwise pay for themselves in cash (“hard dollars”). The availability of soft dollars creates an incentive for advisers to use broker-dealers to obtain soft dollar research rather than for trade execution quality. Section 17(e)(1) of the 1940 Act requires fund advisers to obtain only soft dollar services that are “brokerage and research” services under Section 28(e) of the Securities Exchange Act. Section 28(e) permits an adviser to pay more than the lowest commission rate in order to receive research services from a broker-dealer so long as the adviser determines in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.

A fund board should request that the adviser demonstrate that it has operated within the safe harbor of Section 28(e) and describe its policies and procedures for doing so. Information includes:

- How the adviser identifies the amount and types of research to be obtained;
- How the soft dollar budget is established and how brokerage allocations are made;
- How the adviser determines that its use of soft dollars is within the safe harbor;
- How soft dollar products and services are allocated among clients; and
- How mixed-use products are evaluated.

If the board believes that commissions can be better used, the board should so direct the adviser.

Board Evaluation of the Fund’s Investment Advisory Agreement

Section 15(c) of the 1940 Act requires that the board evaluate the fund’s investment advisory contract annually. The Guidance states that a board should include consideration of soft dollar benefits the adviser receives from fund brokerage in evaluating the adviser’s compensation. Fund directors should, at a minimum, seek information regarding the adviser’s (1) brokerage policies and (2) allocation of the fund’s soft dollar commissions.

Comment Period

Comments are due on or before October 1, 2008.

The proposing release can be found at <http://www.sec.gov/rules/proposed/2008/34-58264.pdf>

For Additional Information

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