SEC PUBLISHES PROPOSED GUIDANCE FOR FUND BOARDS OF DIRECTORS

On July 30, 2008, the Securities and Exchange Commission (the "SEC") published for comment proposed guidance to boards of directors of registered investment companies ("funds") regarding their responsibilities in overseeing the portfolio trading practices of a fund's investment adviser (the "Guidance").[1] The Guidance focuses on the role of the board in overseeing the adviser's trading policies and procedures, including the adviser's use of fund brokerage commissions, and provides examples of information that the board should request from the adviser. The Guidance separately requests comment on whether to propose new disclosure requirements regarding brokerage commission arrangements for the benefit of fund shareholders and other clients of an adviser. Comments regarding the Guidance should be submitted by October 1, 2008. We discuss highlights of the Guidance below.

Duties and Responsibilities of Fund Boards of Directors. The Guidance explains that the directors of a fund generally are subject to a duty of care and a duty of loyalty imposed by state or common law, and to specific fiduciary responsibilities imposed by the Investment Company Act of 1940 (the "1940 Act"). A director has a related duty to be reasonably informed about the matters relating to the fund for which he or she has oversight responsibility. In particular, these duties and responsibilities require a director to be informed about an adviser's trading practices and, more specifically, how the adviser fulfills its duty to seek best execution when trading portfolio securities for the fund. The Guidance states that the board should obtain sufficient information from the fund's adviser to adequately reveal conflicts of interest and to determine how the conflicts are being managed, and describes specific items of information that the board should obtain from the adviser relating to its portfolio trading practices.

Board Oversight of an Adviser's Duty to Seek Best Execution. An investment adviser is subject to fiduciary responsibilities to its clients and, specifically, has the duty to seek best execution of the transactions that it undertakes for its clients.[2] The adviser may have incentives, however, to obtain certain benefits from trading activities for a fund that serve the adviser's own or another client's interests. The Guidance notes particularly that conflicts of interest may arise when an adviser executes trades through an affiliate, determines allocations of trades among clients, trades securities between clients, and uses client brokerage commissions to pay for research and brokerage products and services. A fund board is required to approve the fund adviser's policies and procedures based on a finding that they are reasonably designed to prevent violations of the

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[1] Securities Exchange Act Release No. 58264 (July 30, 2008), 73 Fed. Reg. 45646.

[2] The Guidance states: "[I]n seeking best execution, an investment adviser must seek to 'execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is the most favorable under the circumstances.'" 73 Fed. Reg. at 45650 (footnote omitted).

Federal securities laws. To fulfill these obligations, the board should be "sufficiently familiar" with the adviser's trading practices to satisfy itself that the adviser is meeting its fiduciary obligations and is acting in the best interests of the fund. For example, board directors must stay up-to-date in their understanding of trading venues as the securities markets grow more complex, such as the proliferation of alternative trading systems where the adviser can trade securities for the fund. The SEC provides examples of approaches that boards have taken to educate themselves on such developments. The Guidance also describes the data that directors should seek from a fund's adviser in evaluating the adviser's policies and procedures regarding its best execution obligations.

Board Oversight of an Adviser's Use of Fund Brokerage Commissions. A main focus of the Guidance is on an adviser's conflicts of interest in using fund assets to obtain brokerage and research services when the adviser trades portfolio securities on behalf of the fund. Section 28(e) of the Securities Exchange Act of 1934 provides a "safe harbor" from charges of breach of fiduciary duty if the adviser pays more than the lowest available commission rate in effecting securities trades for a client, as long as the adviser determines, in good faith, that the amount of the commission paid is reasonable in relation to the value of brokerage and research products and services provided by broker-dealers to the adviser, and the adviser uses eligible products and services in performing its investment advisory responsibilities.[3] The Guidance states that the adviser should demonstrate to the fund board that the adviser has satisfied the elements of the statute. Moreover, to determine whether the fund's brokerage commissions are being used in the best interests of the fund, the directors need to understand the procedures in place to address the adviser's conflicts of interest and also must provide oversight of the adviser's use of fund brokerage commissions, such as by examining how the adviser allocates soft dollar products and services among its clients. Even though Section 28(e) permits an adviser to consider the value of soft dollar benefits to all accounts for which it exercises investment discretion, and not just to the client whose trades generated the commissions, the Guidance makes it clear that the statute does not absolve fund directors from their obligation to reasonably determine that the adviser is using the fund's brokerage in the best interests of the fund and its shareholders. The Guidance repeatedly states that the board should obtain information from the adviser as to whether the products and services acquired by the adviser with the fund's brokerage commissions are being used to benefit the adviser's other clients and, if so, whether the adviser is acting in the best interests of the fund.

Section 15(c) of the 1940 Act. Section 15(c) of the 1940 Act requires a fund board to review the adviser's compensation in connection with its annual review of the advisory contract. In this regard, the Guidance identifies specific information that a fund board should request from the fund's adviser regarding its use of fund brokerage, including soft dollar arrangements.

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[3] *See Commission Publishes Interpretive Guidance and Seeks Additional Comments on "Soft Dollars" Safe Harbor*, Willkie Farr & Gallagher LLP Client Memorandum (July 24, 2006), available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/2308/SEC_Publishes_Interpretive_Guidance.pdf.

<u>Disclosure to Other Advisory Clients and Fund Investors</u>. The SEC is soliciting comment on whether investment advisers should be required to disclose additional information to clients about portfolio trading practices to improve the current level of soft dollar disclosure. The SEC also asks whether advisers should be required to provide their clients with customized information about how their individual brokerage commissions are being used. In seeking comment on these areas, the SEC is revisiting a 1995 soft dollar disclosure proposal that has not been adopted,[4] and a pending proposal to amend Part II of Form ADV to enhance disclosure of soft dollar practices.[5]

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August 8, 2008

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[4] *Disclosure by Investment Advisers Regarding Soft Dollar Practices*, SEC Release No. IA-1469 (Feb. 14, 1995), 60 Fed. Reg. 9750.

[5] *Amendments to Form ADV*, SEC Release No. IA-2711 (Mar. 3, 2008), 73 Fed. Reg. 13958.