Issued in Fort Worth, Texas, on July 27, 2008.

Mark R. Schilling,

Acting Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. E8–17992 Filed 8–5–08; 8:45 am]

BILLING CODE 4910–13–P

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 230, 232, 239, and 274

[Release Nos. 33–8949; IC–28346; File No. S7–28–07]

RIN 3235–AJ44

Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule; reopening of comment period.

SUMMARY: The Securities and Exchange Commission is reopening the period for public comment on amendments it originally proposed in Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)]. The rule proposal would, if adopted, require key information to appear in plain English in a standardized order at the front of the mutual fund prospectus; and permit a person to satisfy its mutual fund prospectus delivery obligations under section 5(b)(2) of the Securities Act of 1933 by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.

DATES: Comments should be received on or before August 29, 2008.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*);
- Send an e-mail to *rule-comments@sec.gov*. Please include File No. S7–28–07 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File No. S7–28–07. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Deborah D. Skeens, Senior Counsel, Office of Disclosure Regulation, Division of Investment Management, at (202) 551–6784, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–5720.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is reopening the period for public comment on proposed rule and form amendments that are intended to enhance the disclosures that are provided to mutual fund investors. These amendments were proposed on November 21, 2007,[1] and the comment period initially closed on February 28, 2008. The Commission's proposal would, if adopted, require key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus. The proposals also would permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act of 1933 by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site. Upon an investor's request, mutual funds would also be required to send the statutory prospectus to the investor.

The Commission recently engaged a consultant to conduct focus group interviews and a telephone survey concerning investors' views and opinions about various disclosure documents filed by companies, including mutual funds. During this process, investors participating in focus groups were asked questions about, among other things, a hypothetical summary prospectus. Investors participating in the telephone survey were asked questions relating to several disclosure documents, including mutual fund prospectuses. We have placed in the comment file (available at *http://www.sec.gov*) for the proposed rule the following documents from the investor testing that relate to mutual fund prospectuses and the proposed summary prospectus: (1) The consultant's report concerning focus group testing of the hypothetical summary prospectus and related disclosures; (2) transcripts of focus groups relating to the hypothetical summary prospectus and related disclosures; (3) disclosure examples used in these focus groups; and (4) an excerpt from the consultant's report concerning the telephone survey of individual investors. In order to provide all persons who are interested in this matter an opportunity to comment on these additional materials, we believe that it is appropriate to reopen the comment period before we take action on the proposal.

We invite additional comment on the proposal in light of these materials, and on any other matters that may have an effect on the proposal.

Accordingly, we will extend the comment period until August 29, 2008.

By the Commission.

Dated: July 31, 2008.

Florence E. Harmon,

Acting Secretary.

[FR Doc. E8–18036 Filed 8–5–08; 8:45 am]

BILLING CODE 8010–01–P

[1] Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)].

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275

[Release Nos. 34–58264; IC–28345; IA–2763 File No. S7–22–08]

RIN 3235–AJ45

Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors With Respect to Investment Adviser Portfolio Trading Practices

AGENCY: Securities and Exchange Commission.

ACTION: Proposed guidance; request for comment.

SUMMARY: The Securities and Exchange Commission is publishing for comment this proposed guidance to boards of directors of registered investment companies to assist them in fulfilling their fiduciary responsibilities with

respect to overseeing the trading of investment company portfolio securities. The guidance focuses on the role of an investment company board in overseeing the best execution obligations of the investment adviser hired to invest in securities and other instruments on the investment company's behalf. In this respect, we address the conflicts of interest that may exist when an investment adviser uses an investment company's brokerage commissions to purchase services other than execution, such as the purchase of brokerage and research services through client commission arrangements. The Commission also is requesting comment on whether to propose that advisers be subject to new disclosure requirements concerning the use of client commission arrangements to investment company shareholders and other investment advisory clients.

DATES: Comments should be received on or before October 1, 2008.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an e-mail to *rule-comments@sec.gov*. Please include File Number S7–22–08 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Please follow the instructions provided for submitting comments.

Paper Comments

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–22–08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549 on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Matthew N. Goldin, Senior Counsel, Karen L. Rossotto, Advisor to the Director, or Thomas R. Smith, Jr., Senior Advisor to the Director, Office of the Director, at 202–551–6720, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–0506.

I. Introduction and Summary

Many investment advisers, in connection with trades placed on behalf of their registered investment company, or "fund," clients, receive brokerage and research services in reliance on the safe harbor provided under section 28(e) [1] of the Securities Exchange Act of 1934 ("Exchange Act").[2] In recent years, changes in client commission practices, evolving technologies, and marketplace developments have transformed the brokerage and investment management industries and securities trading practices. In recognition of changing market conditions and current industry practices, in July 2006, we issued an interpretive release that provided guidance to investment advisers with respect to, among other things, the scope of the safe harbor provided under section 28(e) when advisers use brokerage commissions to purchase brokerage and research services for their managed accounts.[3] In addition to providing guidance to investment advisers on their use of soft dollars, we believe it is important to provide guidance to fund boards of directors concerning their responsibilities to oversee the adviser's satisfaction of its best execution obligations, including the adviser's use of fund brokerage commissions and the overall transaction costs that the fund incurs when the fund buys or sells portfolio securities.[4] As we have stated previously, transaction costs are a concern for fund investors for two reasons.[5] First, for many funds, the amount of transaction costs incurred may be substantial.[6] Second, fund advisers are subject to a number of potential conflicts of interest in conducting portfolio transactions on behalf of clients that are funds.[7] Fund brokerage commissions, which are paid out of fund assets, may, for example, be used to obtain brokerage and research services under section 28(e) of the Exchange Act that might otherwise be paid for directly by the fund's investment adviser.

We recognize that conflicts of interest are inherent when an investment adviser manages money on behalf of multiple clients. As discussed in section II of this Release, conflicts are also inherent in the external management structure of funds. Investment advisers are required to disclose material conflicts of interest to their clients, and those conflicts should be managed appropriately. Fund directors play a pivotal role in overseeing conflicts of interest investment advisers face when they have funds as clients. As explained in further detail in section III of this Release, fund transaction costs may not be readily apparent to investors. It is imperative that the fund's directors both understand and scrutinize the payment of transaction costs by the fund [8] and determine that payment of transaction costs is in the best interests of the fund and the fund's shareholders.[9] Although

[1] 15 U.S.C. 78bb(e). For a discussion of the section 28(e) safe harbor, see *infra* section III.C. Whereas section 28(e) refers to a money manager as a "person * * * [who] exercise[s] * * * investment discretion with respect to an account," we refer to money managers to funds in this Release as "investment advisers."

[2] 15 U.S.C. 78a.

[3] *Commission Guidance Regarding Client Commission Practices Under section 28(e) of the Securities Exchange Act of 1934,* Exchange Act Release No. 54165 (July 18, 2006) [71 FR 41978 (July 24, 2006)] ("2006 Release").

[4] *See infra* section III (discussing fund directors' obligations with respect to overseeing advisers' trading of fund portfolio securities). Broadly defined, a fund's transaction costs include all of its costs that are associated with trading portfolio securities. Transaction costs may include, among other things, commissions, spreads, market impact costs, and opportunity costs. *Concept Release: Request for Comments on Measures to Improve Disclosure of Mutual Fund Transaction Costs,* Investment Company Act Release No. 26313 (Dec. 18, 2003) [68 FR 74820 (Dec. 24, 2003)] ("Concept Release"), at section II.A. For purposes of this Release, the use of the term "securities" includes all instruments that an investment company may invest in under the Investment Company Act of 1940 [15 U.S.C. 80a] ("Investment Company Act").

[5] *See* Concept Release at section I. However, we are aware that the interests of a fund's adviser and the fund's investors generally are aligned when an adviser places fund trades because advisers typically seek to minimize transaction costs due to the fact that such costs may detract from the fund's performance.

[6] For example, one study estimates that the average annual trading cost for a sample of 1706 U.S. equity funds during the period 1995–2005 was almost 20 percent higher than the average expense ratio for those funds. These estimates include the effect of commissions, spreads, and market impact costs. Roger M. Edelen, Richard Evans & Gregory Kadlec, *Scale Effects in Mutual Fund Performance: The Role of Trading Costs* (working paper dated March 17, 2007), available at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=951367.*

[7] *See* Concept Release at section I.

[8] *See id. See also infra* section II at note 26 and accompanying text (discussing the external management structure of most funds).

[9] *See Role of Independent Directors of Investment Companies,* Investment Company Act Release No. 24082 (Oct. 14, 1999) [64 FR 59826 (Nov. 3, 1999)], at nn.7 & 12 ("Mutual funds are formed as corporations or business trusts under state law and, like other corporations and trusts, must be operated for the benefit of their shareholders. * * * Under state law, directors are generally responsible for the

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directors are not required or expected to monitor each trade, they should monitor the adviser's trading practices and the manner in which the adviser fulfills its obligation to seek best execution when trading fund portfolio securities.[10] In doing so, the fund's board should demand, and the fund's adviser must provide, all information needed by the fund's board to complete this review process.[11] Without sufficient oversight by the fund's board, transaction costs might inappropriately include payment for services that benefit the fund's adviser at the expense of the fund and that the board believes should be paid directly by the adviser rather than with fund assets.

We have received requests from fund directors for guidance on our view of their responsibilities in overseeing the activities of the investment advisers that trade their funds' portfolio securities. These requests include inquiries as to how directors may properly fulfill their responsibilities with respect to overseeing an adviser's satisfaction of its best execution obligations, including the adviser's trade execution practices and the adviser's use of fund brokerage commissions.[12] 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.[13]

Our proposed guidance would not impose any new or additional requirements. Rather, it is intended to assist fund directors in approaching and fulfilling their responsibilities of overseeing and monitoring the fund adviser's satisfaction of its best execution obligations and the conflicts of interest that may exist when advisers trade the securities of their clients that are funds.[14] In developing this proposed guidance, we have taken into account the wide variety of funds and advisers in terms of size, asset classes, complexity, and operations. We have also considered the changing market environment in the brokerage and investment management industries.[15] We feel that with rapidly evolving market conditions and trading practices, it is appropriate to give guidance at this time. For these reasons, we are proposing guidance for fund directors to consider in performing their responsibilities and in determining what is appropriate in light of their fund's particular circumstances.

Our intention in this proposed guidance is to assist boards. We wish to provide guidance that is relevant, useful, and beneficial to fund directors in fulfilling their responsibilities to act in the best interest of investors in this area. We request comment on all aspects of our proposed guidance to help us in achieving this goal. In addition, as the evolving nature of brokerage practices greatly influences how directors approach their oversight responsibilities in this area, we specifically request comment on the current state of the brokerage and investment management industries and its effect on advisers' trading of fund portfolio securities.

II. Summary of Law Regarding Fiduciary Responsibilities of Investment Company Directors

In fulfilling their responsibilities to a fund that they oversee, fund directors should understand the nature and source of their legal obligations to the fund and the fund's shareholders. Because funds are generally formed as corporations, business trusts, or partnerships[16] under state law, fund directors and trustees, like other corporate directors, are subject to a "duty of care" and a "duty of loyalty" under state and common law fiduciary principles,[17] as well as the obligations imposed on them under the Investment Company Act.[18]

A director's duty of care generally requires a fund director to perform his or her oversight responsibilities with the care of an ordinarily prudent person in a like position under similar circumstances.[19] The duty of care thus establishes the degree of attention and consideration required of a director in matters related to the fund he or she oversees. As such, a director's duty of care incorporates a duty to be informed, requiring that a director be reasonably informed about an issue before making a decision relating to that issue.[20] To be reasonably informed about an issue, a director must inform him or herself of all material information regarding that issue reasonably available to him or her.[21] In fulfilling these obligations, a fund director may rely on written and oral reports provided by management, auditors, fund counsel, the fund's chief compliance officer ("CCO"), and other experts and committees of the board when making decisions, so long as the director reasonably believes that the reports are reliable and competent with respect to the relevant matters.[22]

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oversight of all of the operations of a mutual fund.'').

[10] The directors of an investment company have a continuing fiduciary duty to oversee the company's brokerage practices. *See* 2006 Release at n.6 (citing *Order Approving Proposed Rule Change and Related Interpretation under section 36 of the Investment Company Act,* Investment Company Act Release No. 11662 (Mar. 4, 1981) [46 FR 16012 (Mar. 10, 1981)]). *See also* 2 Tamar Frankel, Regulation of Money Managers 67 (1978) (''The directors should examine the adviser's practices in placing portfolio transactions with broker dealers and the use of the brokerage business for the benefit of the adviser or its affiliates, and ensure that there are no violations [ ] of the law. * * *'') (citing *Lutz* v. *Boas,* 39 Del. Ch. 585, 171 A.2d 381 (1961) *and* William J. Nutt, *A Study of Mutual Fund Independent Directors,* 120 U. Pa. L. Rev. 179, 181 (1971)).

[11] *See Concept Release* at section I.

[12] In connection with these requests for guidance, fund directors have informed us that fund boards are spending increasing amounts of time on trading practices in light of the growing complexity in this area.

[13] At the July 12, 2006 open meeting at which the Commission considered the 2006 Release, several of the Commissioners specifically noted that guidance for fund boards was a critical element in protecting investors against abuses in this area. An electronic link to an archived webcast of the open meeting is available at *http://www.connectlive.com/events/secopenmeetings.*

[14] *See infra* section III. *See also* 2006 Release at section II.A.

[15] In light of the advancements in the market and the continuously evolving technology influencing industry practices, the Commission staff talked with a variety of investment advisers and industry representatives, including independent fund directors and directors' counsel, to help ensure that our proposed guidance today reflects actual market practices and is based on factual industry experience.

[16] *See, e.g.*, A. Joseph Warburton, *Should Mutual Funds Be Corporations: A Legal & Econometric Analysis,* 33 Iowa J. Corp. L. 745, 748–49 (2008).

[17] *See, e.g.*, Md. Code Ann., Corps. and Ass'ns § 2–405.1(a) (2008) (requiring a director to perform his duties: ''(1) In good faith; (2) In a manner he reasonably believes to be in the best interests of the corporation; and (3) With the care that an ordinarily prudent person in a like position would use under similar circumstances.'').

[18] 15 U.S.C. 80a. *See supra* note 4.

[19] *See, e.g.*, Model Bus. Corp. Act Ann. § 8.30(b) (3d ed. 2002); Md. Code Ann., Corps. and Ass'ns § 2–405.1(a)(3) (2008).

[20] *See, e.g., Smith* v. *Van Gorkom,* 488 A.2d 858 (Del. 1985) (explaining that, although directors are assumed to have been informed in making a business decision, when the burden of proving that a board was insufficiently informed is met, the board will have been found to have breached its duty of care).

[21] *See id.* at 872 (discussing the standard for determining whether a director's business judgment is informed).

[22] *See, e.g., Graham* v. *Allis-Chalmers Manufacturing Co.,* 188 A.2d 125, 130 (1963) (explaining that, under general principles of the common law, a director is entitled to rely on corporate summaries, reports, and records so long as he or she has not ''recklessly reposed confidence in an obviously untrustworthy employee, [ ] refused or neglected cavalierly to perform his duty as a director, or [ ] ignored either willfully or through inattention obvious danger signs of employee wrongdoing.''). A director should be satisfied not only that the person providing the report or opinion is doing so about a matter within his or her knowledge or expertise and has an appropriate basis for the opinion, but also that the scope of the

A director's duty of loyalty requires him or her to act in the best interests of the fund and the fund's shareholders.[23] The duty of loyalty encompasses a director's obligations to avoid conflicts of interest with the fund and the fund's shareholders, not to put his or her personal interests before the interests of the fund and the fund's shareholders, and not to profit from his or her position as a fiduciary.[24]

In addition to statutory and common law obligations, fund directors are also subject to specific fiduciary obligations relating to the special nature of funds under the Investment Company Act.[25] Unlike typical operating companies, funds ordinarily do not have any employees that are truly their own, but rather are generally formed and managed by a separately owned and operated sponsor, commonly an investment adviser.[26] This external management structure of most funds may at times create conflicts of interest for investment advisers with clients that are funds. When it enacted the Investment Company Act, Congress recognized the potential for abuse created by the unique structure of funds.[27] To protect fund shareholders, the Act requires that each registered fund be governed by a board of directors with the authority to supervise the fund's operations.[28] The Act further requires that at least 40 percent of a fund's board be independent in order to serve as ''independent watchdogs'' in monitoring the fund's managing organization.[29] A fund board has the responsibility, among other duties, to monitor the conflicts of interest facing the fund's investment adviser and determine how the conflicts should be managed to help ensure that the fund is being operated in the best interest of the fund's shareholders.[30]

III. Board Oversight of Investment Adviser Trading Practices

In overseeing the use of fund assets and in monitoring the conflicts of interest faced by a fund's investment adviser, a fund board must consider the investment adviser's practices when it trades the fund's portfolio securities.[31] A fund's investment adviser is a fiduciary with respect to the fund and therefore must act in the fund's best interest.[32] Lower transaction costs generally are in the mutual interest of a fund's adviser and the fund's investors, and advisers typically seek to minimize transaction costs when trading fund securities so as not to detract from the fund's performance. At times, however, there may be incentives for an investment adviser to compromise its fiduciary obligations to the fund in its trading activities in order to obtain certain benefits that serve its own interests or the interests of other clients. These conflicts of interest may exist, for example, when an adviser executes trades through an affiliate, when it determines the allocation of trades among its clients, and when it trades securities between clients. In addition, the use of fund brokerage commissions to pay for research and brokerage services may give incentives for advisers to disregard their best execution obligations when directing orders to obtain brokerage commission services. It also may give incentives for advisers to trade the fund's securities in order to earn credits for fund brokerage commission services. In accordance with its fiduciary obligations and provisions of the Advisers Act, an adviser must make full and fair disclosure of these conflicts to a client and disclose how the adviser will manage each conflict before the adviser may engage in conduct that constitutes a conflict.[33]

The fund's board, in providing its consent on the fund's behalf, should be sufficiently familiar with the adviser's trading practices to satisfy itself that the adviser is fulfilling its fiduciary obligations and is acting in the best interest of the fund. In some cases where the Commission has adopted

report bears on the matter being decided. *See Van Gorkom,* 488 A.2d at 875. In addition, to fulfill the duty of care, a director needs a well-informed decision-making process. This process may include, among other things, asking for and reviewing regular financial and other reports, questioning managers and outside experts about the meaning and implications of reports, and making inquiries when there are specific causes for concern. *Id.*

[23] *See, e.g., Strougo* v. *Scudder, Stevens and Clark, Inc.,* 964 F. Supp. 783, 801 (S.D.N.Y. 1997) (citing Md. Code Ann., Corps. and Assn's § 2–405.1(a)(1) (requiring corporate directors to perform their duties in ''good faith'') and James J. Hanks, Jr., Maryland Corporation Law § 6.6(b) (1995–1 Supp.) (explaining that a director's duty to act in 'good faith' is generally synonymous with the duty of loyalty or the duty of fair dealing)). *See also Pepper* v. *Litton,* 308 U.S. 295, 310–311 (1939) (stating that a fiduciary ''cannot serve himself first and his *cestuis* second'').

[24] *See, e.g., Guth* v. *Loft, Inc.*, 5 A.2d 503, 510 (Del. Ch. 1939) (''Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests''); *see also Pepper,* 308 U.S. at 310–311 (stating that a fiduciary ''cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements.''). *See also* Fed. Regulation of Sec. Comm., Am. Bar Ass'n, Fund Director's Guidebook 98 (3d ed. 2006) (''Simply put, directors should not use their position for personal profit, gain, or other personal advantage.'').

[25] *See, e.g., Strougo*, 964 F. Supp. at 798 (holding that a fund shareholder has a private right of action under section 36(a) of the Investment Company Act against the independent directors of a fund for breach of fiduciary duty involving personal misconduct). *See also Protecting Investors: A Half Century of Investment Company Regulation,* Division of Investment Management 251 (May 1992) (''Protecting Investors'').

[26] *See* Protecting Investors 251 n.3.

[27] *See* Investment Company Act section 1(b)(2) [15 U.S.C. 80a–1(b)(2)]; U.S. Sec. and Exch. Comm'n, Report on Investment Trusts and Investment Companies, H.R. Doc No. 76–279, Part III (1939). See also Joseph F. Krupsky, *The Role of Investment Company Directors,* 32 BUS. LAW. 1733, 1737–40 (1977); William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179, 181 (1971).

[28] *See* S. Rep. No. 91–184, at 4902–03 (1969) (''The directors of a mutual fund, like directors of any other corporation will continue to have * * * overall fiduciary duties as directors for the supervision of all of the affairs of the fund.'').

[29] 15 U.S.C. 80a–10(a). *See also Burks* v. *Lasker,* 441 U.S. 471, 484–485 (1979) (''Congress' purpose in structuring the Act as it did is clear * * * it 'was designed to place the unaffiliated directors in the role of ''independent watchdogs.'' ' (quoting Tannenbaum v. Zeller, 552 F.2d 402 (2d Cir. 1977)).

[30] *See Tannenbaum,* 552 F.2d at 406 (noting that the independent director requirements under the Investment Company Act, in particular, were designed to ensure that ''mutual funds would operate in the interest of all classes of [funds'] securities holders, rather than for the benefit of investment advisers, directors or other special groups.'').

[31] *See* 2006 Release at n.6 (citing *Order Approving Proposed Rule Change and Related Interpretation under Section 36 of the Investment Company Act,* Investment Company Act Release No. 11662 (Mar. 4, 1981) [46 FR 16012 (Mar. 10, 1981)] (''The directors of an investment company have a continuing fiduciary duty to oversee the company's brokerage practices.'')). *See also Compliance Programs of Investment Companies and Investment Advisers,* Advisers Act Release No. 2204 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] (''Compliance Release''), at Section II.A.2.b (requiring that a fund's board approve the policies and procedures of the fund's service providers, including its investment adviser; the approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal securities laws by the fund's service providers). We have stated that we expect that the adviser's compliance policies and procedures will address, to the extent that they are relevant, the adviser's trading practices. *See* Compliance Release at II.A.1.

[32] Investment advisers are fiduciaries and have an obligation under the Investment Advisers Act of 1940 [15 U.S.C. 80b] (''Advisers Act'') and state law to act in the best interest of their clients. *See* Restatement (Second) of Trusts § 170(1) (2008) (''The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary''); *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 191 (1963) (''The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship. * * * ' '' (quoting 2 LOSS, Securities Regulation 1412 (2d ed. 1961))); *Transamerica Mortgage Advisors, Inc.* v. *Lewis,* 444 U.S. 11, 17 (1979) (noting that the legislative history of the Advisers Act ''leaves no doubt that Congress intended to impose enforceable fiduciary obligations'' on investment advisers).

[33] *See Capital Gains,* 375 U.S. at 191, 196–197 (''The Investment Advisers Act of 1940 reflects * * * a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser, consciously or unconsciously, to render advice which was not disinterested.'').

exemptive rules that permit funds to engage in transactions otherwise prohibited by the Investment Company Act, the Commission has imposed conditions designed to address certain conflicts of interest faced by advisers by mandating that directors take particular action in evaluating those conflicts.[34] In other cases, the Commission has determined that the conflicts relating to a particular practice are unmanageable and has therefore prohibited advisers' activities in that area altogether.[35]

Two specific areas where conflicts may arise when an adviser trades a fund's portfolio securities concern the adviser's obligation to seek best execution and to otherwise use fund assets, including brokerage commissions, in the best interest of the fund. The following sections provide guidance on the types of information a fund board should seek in order to evaluate whether the adviser to its fund has fulfilled its obligations to the fund with respect to these concerns.

A. Board Oversight of an Investment Adviser's Duty To Seek Best Execution and Consideration of Transaction Costs

As a fiduciary to a client that is a fund, an investment adviser has the duty to seek best execution of securities transactions it conducts on the fund's behalf.[36] As we have stated previously, in 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.'' [37] In this regard, in seeking to maintain best execution on behalf of a client that is a fund, an adviser should consider factors beyond simply commission rates or spreads,[38] including ''the full range and quality of a broker's services in placing brokerage. * * *'' [39] These might include, among other things, the value of research provided, execution capability, financial responsibility, and responsiveness to the adviser.[40]

When trading portfolio securities of a client that is a fund, an adviser should consider factors related to minimizing the overall transaction costs incurred by the fund.[41] Transaction costs consist of explicit costs that can be measured directly, such as brokerage commissions, fees paid to exchanges, and taxes paid, as well as implicit costs that are more difficult to quantify. Implicit costs, which may include, among other things, bid/ask spreads, the price impact of placing an order for trading in a security, and missed trade opportunity cost, may exceed greatly a transaction's explicit costs.[42] Price impact and opportunity cost can be influenced by a variety of factors—each of which should be considered by an investment adviser—such as the anonymity of the parties to the trade, the willingness of the intermediary to commit capital to facilitate the trade, and the speed and price of the execution. Investment advisers also can take into account the quality and utility of any research provided by the broker-dealer.[43]

An aspect of an adviser's best execution process that directors should also consider is the adviser's decision whether to use an alternative trading system. Newer trading venues, such as ''dark pools,'' [44] and the use of advanced mathematical models or algorithmic trading systems, crossing networks, and other alternative trading systems, are increasingly prevalent.[45] Although the use of such trading venues may provide funds certain benefits (such as potentially lower execution costs),[46] they can also raise challenges to funds in certain situations.[47]

We ask for comment on how changes in the brokerage industry should affect a fund board's oversight of the trading practices of the fund's adviser. Is our discussion of the brokerage industry (as relevant to funds and their advisers) accurate? Are there other considerations with respect to the brokerage industry we should take into account?

We understand that investment advisers with clients that are funds employ a wide range of procedures

[34] *See, e.g.*, Investment Company Act rule 10f–3(c)(10) [17 CFR 270.10f–3(c)(10)] (fund boards must adopt procedures for purchases by the fund of securities from an affiliated underwriter and assess compliance on a quarterly basis); Investment Company Act rule 17a–7(e) [17 CFR 270.17a–7(e)] (fund boards must adopt procedures for purchases from and sales to affiliated funds and assess compliance on a quarterly basis); Investment Company Act rule 17a–8(a) [17 CFR 270.17a–8(a)] (fund boards must make certain determinations in evaluating mergers with affiliated funds); and Investment Company Act rule 17e–1(b) [17 CFR 270.17e–1(b)] (fund boards must adopt procedures for brokerage transactions with affiliates and assess compliance on a quarterly basis).

[35] *See, e.g., Prohibition on the Use of Brokerage Commissions to Finance Distribution*, Investment Company Act Release No. 26591 (Sep. 2, 2004) [69 FR 54728 (Sep. 9, 2004)], at section VII.E (explaining that the Commission's adoption in 2004 of Investment Company Act rule 12b–1(h) [17 CFR 270.12b–1(h)], which, among other things, prohibits a fund from using brokerage commissions to pay for the distribution of the fund's shares, was based on a conclusion that the practice of trading brokerage business for sales of fund shares poses conflicts of interest that the Commission believed to be ''largely unmanageable'').

[36] *See Interpretive Release Concerning the Scope of section 28(e) of the Securities Exchange Act of 1934 and Related Matters*, Exchange Act Release No. 23170 (Apr. 23, 1986) [51 FR 16004, 16011 (Apr. 30, 1986)] (''1986 Release''), at Section V (explaining that an investment adviser has the obligation to seek ''best execution'' of a client's transaction); Delaware Management Company, Inc., 43 S.E.C. 392 (1967); Arleen W. Hughes, 27 S.E.C. 629 (1948), *aff'd sub nom. Hughes* v. *SEC*, 174 F.2d 969 (D.C. Cir. 1949).

[37] 1986 Release at section V.

[38] A fund may incur spread costs rather than commissions when a dealer trades with it on a principal basis. Spread costs are incurred indirectly when a fund either buys a security from a dealer at the ''asked'' price or higher or sells a security to a dealer at the ''bid'' price or lower. The difference between the bid price and the asked price is known as the ''spread.'' Spread costs include both an imputed commission on the trade as well as any market impact cost associated with the trade. Dealer spreads compensate broker-dealers for, among other things, maintaining a market's trading infrastructure (i.e., price discovery and execution services), the broker-dealer's cost of capital, and its assumption of market risk. Spreads may also reflect the impact of large orders on the price of a security. The proportion of these two components varies among different trades. Concept Release at section II.A.2.

[39] 1986 Release at section V.

[40] *Id.*

[41] *See id.*

[42] For a more detailed discussion of explicit and implicit transaction costs, see Concept Release at section II.A.

[43] *See* 1986 Release at section V (''A money manager should consider the full range and quality of a broker's services in placing brokerage including, among other things, the value of research provided. * * *''). For further discussion regarding evaluation of broker-dealer research services, see *infra* section III.D.

[44] For purposes of this release, our references to the term ''dark pools'' refer to markets that do not display quotes, but rather execute trades internally without displaying liquidity to other participants. A number of markets combine non-displayed liquidity with display of quotes. A substantial portion of the trading volume of these markets may result from interaction of orders with their non-displayed liquidity. *See, e.g.*, Elizabeth Cripps, *Shedding Light on the Dark Liquidity Pools*, FTMandate, May 2007, available at *http://www.ftmandate.com/news/printpage.php/aid/1442/Shedding_light_on_the_dark_liquidity_pools.html.*

[45] One recent report noted that although dark pools currently make up seven to ten percent of equities' share volume in the U.S., that percentage is steadily increasing. Celent, LLC, Dark Liquidity Pools in Europe, Canada, and Japan: A U.S. Phenomenon Goes Abroad (2007). *See also* David Bogoslaw, *Big Traders Dive Into Dark Pools*, Business Week, Oct. 3, 2007, available at *http://www.businessweek.com/investor/content/oct2007/pi2007102_394204.htm* (noting that the Aite Group predicted in September 2007 that exchanges' market share of U.S. equity trading would continue to decline from the current 75 percent, before stabilizing at around 62 percent by 2011, with alternative trading systems, including dark pools, intensifying fragmentation of the marketplace).

[46] Execution costs may be lower on alternative trading systems. *See, e.g.*, Jennifer Conrad, Kevin Johnson & Sunil Wahal, *Insitutional Trading and Alternative Trading Systems*, 70 J. of Fin. Econ. 99 (2003).

[47] For example, we understand that an adviser managing a fund that invests in companies with smaller capitalizations and more illiquid securities may need an executing broker-dealer to have experience and access to a particular market or one with expertise in a certain geographical area or industry. Advisers to these types of funds have indicated that they must rely on a relatively large number of brokers—especially where markets in niche securities have not developed on newer trading venues—to provide the execution and research they need with respect to a particular asset class.

when selecting broker-dealers for fund securities transactions.[48] In consideration of the wide variety of advisers in terms of size and operations, each adviser should determine what trading intermediary selection process is most appropriate for its circumstances.[49] However, as the Commission has stated previously, in its process for choosing trading intermediaries, an adviser should periodically and systematically evaluate the performance of broker-dealers handling its transactions.[50] In addition, the Commission has stated that an investment adviser should address its best execution obligations in the compliance policies and procedures that advisers are required to adopt and implement under rule 206(4)–7 under the Advisers Act.[51] Rule 38a–1 under the Investment Company Act requires that the policies and procedures of a fund adviser be approved by the fund board based on the board's finding that the policies and procedures are reasonably designed to prevent the adviser's violation of the Federal securities laws.[52]

Fund directors should seek relevant data from the fund's investment adviser to assist them in evaluating the adviser's procedures regarding its best execution obligations. These data should typically include, but not be limited to: (i) The identification of broker-dealers to which the adviser has allocated fund trading and brokerage; (ii) the commission rates or spreads paid; (iii) the total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period; and (iv) the fund's portfolio turnover rates. Fund boards may also discuss related matters with the adviser, which may include the following, where applicable:

- The process for making trading decisions and the factors involved in the selection of execution venues and the selection of broker-dealers;
- The means by which the investment adviser determines best execution and evaluates execution quality as well as how best execution is affected by the use of alternative trading systems;
- Who negotiates commission rates, how that negotiation is carried out, whether the amount of commissions agreed to depends on comparative data with respect to commission rates, and generally how transactions costs are measured;[53]
- How the quality of ''execution-only'' trades—trades that do not include payment for any additional research or services beyond execution—is evaluated compared to that of other trades (for example, whether trades that are executed through channels that include an additional soft dollar component are reviewed in comparison with execution-only trades to discern any discrepancies in the quality of execution);
- How the performance of the adviser's traders is evaluated, as well as the aggregate performance of the firm's traders as a whole, how the performance of each broker-dealer the adviser uses for fund portfolio transactions is evaluated, and how problems or concerns that are identified with a trader or a broker-dealer are addressed;
- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser's activities, including the trading intermediary selection process;[54]
- To what extent and under what conditions the adviser conducts portfolio transactions with affiliates;
- The process for trading fixed-income securities and determining the costs of fixed income transactions;
- How the quality of trade execution is evaluated with respect to fixed-income and other instruments traded on a principal basis; and
- If there are international trading activities, how these trades are conducted and monitored.

We acknowledge that not all funds would require an evaluation of each of these factors by their boards. Different factors may be appropriate for different funds, depending on a fund's investment objective, trading practices, and personnel.

We also request comment regarding how boards should approach their obligations to oversee and evaluate the fund adviser's trading practices and procedures. Is there further information fund boards should request that the adviser provide to assist directors in their review?

Once the board receives from the adviser information with respect to the issues outlined above, fund directors should determine whether the adviser's trading practices are being conducted in the best interests of the fund and the fund's shareholders. If these interests are not being best served, the board should direct the adviser accordingly.

In addition, when an investment adviser seeks the fund board's approval of the adviser's compliance policies and procedures, directors should satisfy themselves that the adviser's policies and procedures are reasonably designed, adequate, and being effectively implemented to prevent violations of the Federal securities laws.[55] Directors may evaluate the adviser's compliance policies and procedures through updates from different sources, which may include the fund's or the adviser's CCO or other appropriate sources.[56]

Furthermore, with the rapid development of increased options for trading venues, fund boards need to remain up to date in their familiarity with the evolving market in this area. We understand that fund directors approach educating themselves on

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[48] *See infra* note 77 and accompanying text (discussing the ''broker vote'' process employed by many advisers to evaluate broker-dealers' brokerage and research services).

[49] *See* Compliance Release at section I.A.1 (explaining that, in mandating investment adviser compliance policies and procedures, we elected not to impose a single set of universally applicable required elements because advisers are too varied in their operations).

[50] *See* 1986 Release at section V.

[51] *See* Compliance Release at section II.A.1. Rule 206(4)–7 under the Advisers Act [17 CFR 275.206(4)–7] requires an investment adviser to have written compliance policies and procedures in place that are reasonably designed to prevent it from violating the Advisers Act and rules the Commission has adopted under the Act. The rule does not enumerate specific elements that an adviser must include in its policies and procedures. However, the Commission has stated that it expects an adviser, in designing its policies and procedures, to identify conflicts and other compliance factors creating risk exposure for the firm and its clients in light of the firm's particular obligations, and then design policies and procedures that address those risks. *See id.*

[52] 17 CFR 270.38a–1. *See also* Compliance Release at section II.A.2.

[53] Although we are not suggesting that firms need to do so, we understand that some firms have employed third-party vendors to assist them in measuring best execution through a transaction cost analysis using comparative data from across the industry. We also have been informed that not all companies use the same methodology to measure trading costs and that there are no commonly accepted standards as to how to measure price impact.

[54] Because sub-advisory arrangements take various forms, directors should have an understanding of the structure of these arrangements and whether the adviser is appropriately overseeing the trading activities of the sub-advisers.

[55] 17 CFR 270.38a–1(a)(2)–(3) (requiring that each fund ''[o]btain the approval of the fund's board of directors * * * of the fund's policies and procedures and those of each investment adviser * * * which approval must be based on a finding by the board that the policies and procedures are reasonably designed to prevent violation of the Federal Securities Laws by the fund, and by each investment adviser * * *'' and that each fund ''review, no less frequently than annually, the adequacy of the policies and procedures of the fund and of each investment adviser. * * *''). *See also* Compliance Release at section II.A.2. & II.B.2.

[56] 17 CFR 270.38a–1(a)(4)(iii) (requiring that the fund designate a CCO who must, ''no less than annually, provide a written report to the board that, at a minimum, addresses,'' among other things, ''[t]he operation of the policies and procedures of the fund and each investment adviser. * * *''). *See also* Compliance Release at section II.C.2.

industry developments in various ways.[57]

B. Board Oversight of an Investment Adviser's Use of Fund Brokerage Commissions

When trading portfolio securities on behalf of clients that are funds, there are a number of ways in which an investment adviser may use a portion of fund brokerage commissions to benefit the fund beyond execution of the securities transaction. First, a fund adviser may use a portion of fund brokerage commissions to purchase research and/or research-related services in accordance with section 28(e) of the Exchange Act. The research may be ''proprietary'' research, produced by the broker-dealer executing the securities transaction or its affiliates,[58] or it may be ''third-party research,'' produced or provided by someone other than the executing broker-dealer.[59] Investment advisers also may purchase third-party research themselves using cash payments from their own account, or ''hard dollars.'' Furthermore, investment advisers may obtain proprietary and third-party research through a ''client commission arrangement.'' In a client commission arrangement, an investment adviser agrees with a broker-dealer effecting trades for the adviser's client accounts that a portion of the commissions paid by the accounts will be credited to purchase research either from the executing broker or another broker, as directed by the adviser.[60]

In addition to obtaining research and research-related services with fund brokerage commissions,[61] an adviser may use fund brokerage commissions in other ways. For example, an adviser may utilize a commission recapture arrangement, whereby the fund receives a portion, or rebate, of the brokerage commission (or spread) charged by the broker-dealer handling the trade. Additionally, an investment adviser may use fund brokerage to pay certain providers for services utilized by the fund through an expense reimbursement arrangement with a broker-dealer and/or its affiliates.[62]

We specifically request comment on our discussion of the various uses of fund brokerage. Have we described the use of fund brokerage commissions and client commissions by advisers correctly? Are fund brokerage commissions used in ways that we have not addressed but should address in this proposed guidance?

Because fund brokerage commissions are fund assets, investment advisers have a conflict of interest when they use commissions to obtain research and related services that they would otherwise have to pay for themselves. Advisers therefore are subject to certain requirements when using fund brokerage in this manner. First, section 17(e)(1) of the Investment Company Act prohibits investment advisers to registered investment companies from using soft dollars to obtain research or services outside the confines of the safe harbor provided by section 28(e) of the Exchange Act.[63] Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets,[64] although an investment adviser's use of soft dollars creates opportunities for the adviser to benefit in ways that may not be in the best interest of the fund. These conflicts of interest arise in a number of ways when investment advisers use fund assets in soft dollar programs. For example:

- The use of fund brokerage commissions to buy research may relieve an adviser of having to produce the research itself or having to pay for the research with ''hard dollars'' from its own resources;
- The use of soft dollars may give an adviser an incentive to compromise its fiduciary obligations and to trade the fund's portfolio in order to earn soft dollar credits;
- The availability of soft dollar benefits that an adviser may receive from fund brokerage commissions creates an incentive for an adviser to use broker-dealers on the basis of their research services provided to the adviser rather than the quality of execution provided in connection with fund transactions;
- An adviser may seek to use fund brokerage commissions to obtain

[57] Some ways we have observed that directors educate themselves on developments in this area include: (i) Establishing a committee of the board to specialize in portfolio trading practices; (ii) requiring that the adviser form special committees to consider best execution and the use of client commissions and to provide reports to the board on the adviser's trading activities; (iii) requesting periodic summaries and analyses from officers of the adviser to explain the adviser's portfolio trading practices; (iv) attending trade association events, seminars and/or other education events relating to brokerage practices; (v) subscribing to third-party information providers or retaining experts to ensure that board members remain knowledgeable with respect to market developments; and (vi) periodically meeting with portfolio managers, business unit staff, trading personnel and other employees of the adviser.

[58] *See* Thomas P. Lemke & Gerald T. Lins, Soft Dollars and Other Brokerage Arrangements § 1.04[A] (2005). Proprietary research is often provided to an investment adviser partly as a *quid pro quo* for brokerage business given by the adviser to the broker producing the research. Alternatively, proprietary research may be provided without being expressly requested and considered part of the services obtained in exchange for ''full service,'' or ''bundled,'' commissions that include a sufficient amount of compensation to cover the cost of research. *Id.*

[59] *See id.*

[60] *See* 2006 Release at section III (interpreting section 28(e) to permit the industry flexibility to structure arrangements that are consistent with the statute and best serve investors).

[61] *See infra* note 70 (explaining that only commission-based trades (as opposed to mark-ups or mark-downs or spreads) are covered under the safe harbor in section 28(e) of the Exchange Act).

[62] In expense reimbursement arrangements, also referred to as ''brokerage/service arrangements,'' a broker-dealer typically agrees to pay a fund's service provider fees (such as custodian fees or transfer agency fees) and, in exchange, the fund agrees to direct a minimum amount of brokerage business to the reimbursing broker. The fund adviser usually negotiates the terms of the contract with the service provider, and the fees charged under the contract are paid directly by the broker-dealer. Brokerage/service arrangements may be structurally similar to client commission arrangements. However, unlike client commission arrangements, where the receipt of a benefit by the investment adviser through the use of fund brokerage commissions gives rise to conflicts of interest, brokerage/service arrangements generally do not raise these concerns because they typically involve the use of fund brokerage commissions to obtain services that directly and exclusively benefit the fund. *See Payment for Investment Company Services with Brokerage Commissions*, Securities Act Release No. 7197 (July 21, 1995) [60 FR 38918 (July 28, 1995)] (''1995 Release''), at nn. 1–2 and accompanying text; *see also* 2006 Release at section II.A, n.27.

[63] 15 U.S.C. 80a–17(e)(1). Section 17(e)(1) of the Investment Company Act generally makes it unlawful for any affiliated person of a registered investment company to receive any compensation (other than a regular salary or wages from the company) for the purchase or sale of any property to or for the investment company when that person is acting as an agent other than in the course of that person's business as a broker-dealer. Essentially, section 17(e)(1) may be violated if an affiliated person of a registered investment company, such as an adviser, receives compensation (other than a regular salary or wages from the company) for the purchase or sale of property to or from the investment company. Absent the protection of section 28(e), which provides a safe harbor from liability under other federal and state law, an investment adviser's receipt of compensation—including in the form of brokerage or research services—under a client commission arrangement for the purchase or sale of any property, including securities, for or to the investment company, may constitute a violation of section 17(e)(1). *See U.S.* v. *Deutsch*, 451 F.2d 98, 110–11 (2d Cir. 1971), *cert. denied*, 404 U.S. 1019 (1972). If a fund adviser's client commission arrangement is not consistent with section 28(e), disclosure of the arrangement would not cure any section 17(e)(1) violation. *See* 2006 Release at n.31; 1986 Release at n.55.

[64] An adviser's obligation to act in the best interest of its client imposes a duty on the adviser not to profit at the expense of the client without the client's consent. *See, e.g.*, Restatement (Second) of Trusts § 170 cmt. a, § 216 (1959). Also, section 206 of the Advisers Act establishes federal fiduciary standards governing the conduct of investment advisers. Under sections 206(1) and (2), in particular, an adviser must discharge its duties in the best interest of its clients, and must fully disclose a conflict of interest with a client, before engaging in conduct that constitutes a conflict. *See Transamerica*, 444 U.S. at 17.

research that benefits the adviser's other clients, including clients that do not generate brokerage commissions (such as fixed-income funds), those that are not otherwise paying more than the lowest available commission rate in exchange for soft dollar products or services (i.e., ''paying up'' in commission costs), or those from which the adviser receives the greatest amount of compensation for its advisory services;

- The use of soft dollars may disguise an adviser's true costs and enable an adviser to charge advisory fees that do not fully reflect the costs for providing the portfolio management services; [65]
- The use of fund brokerage commissions to obtain research and other services may cause an adviser to avoid other uses of fund brokerage commissions that may be in the fund's best interest, such as establishing a commission recapture program or fund expense reimbursement arrangement to offset expenses that are paid for with fund assets; [66] and
- In the case of ''mixed-use'' products—for example, research products or services obtained using soft dollars that may serve functions that are not related to the investment decision-making process, such as accounting or marketing—an adviser has a conflict when making an allocation determination between the research and non-research uses of the product as required to fulfill the requirements under section 28(e) of the Exchange Act.[67]

When evaluating an adviser's use of fund brokerage commissions in light of these conflicts, a fund board may determine that such use is in the best interests of the fund.[68]

C. Section 28(e) Under the Securities Exchange Act of 1934

Section 28(e) of the Exchange Act provides a safe harbor that protects investment advisers from liability for a breach of fiduciary duty solely on the basis that the adviser caused an account over which it exercises investment discretion to pay more than the lowest commission rate in order to receive brokerage and research services provided by a broker-dealer, if the adviser determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received.[69] As we have stated, section 17(e)(1) of the Investment Company Act prohibits investment advisers to registered investment companies from obtaining brokerage and research services with fund brokerage commissions outside the section 28(e) safe harbor.[70]

The 2006 Release provides guidance with respect to the appropriate framework for analyzing whether a particular service falls within the ''brokerage and research services'' safe harbor of section 28(e).[71] A fund board should request that the fund adviser inform directors of the policies and procedures the adviser uses to ensure that the types of brokerage and research services the adviser obtains using fund brokerage commissions fall within the safe harbor and that the adviser has not engaged in excessive trading in light of the fund's investment objectives. In turn, in approving the policies and procedures, a board should consider whether they are reasonably designed to ensure that the adviser's use of fund brokerage commissions complies with the section 28(e) safe harbor, as well as all the federal securities laws.[72]

In addition, as we stated in the 2006 Release, to rely on the section 28(e) safe harbor, an adviser must: (i) Determine whether the product or service obtained is eligible research or brokerage under section 28(e); (ii) determine whether the eligible product actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities; and (iii) make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer.[73] We also reaffirmed an investment adviser's essential obligation under section 28(e) to make this good faith determination and that the burden in demonstrating this determination rests on the investment adviser.[74] An adviser should demonstrate to the board that it has met this burden.[75] We specifically request comment on our proposed guidance in this regard. We also request examples of effective practices fund boards employ when evaluating whether an adviser has made

[65] *See infra* section III.E (discussing the obligations of fund advisers and fund boards under section 15(c) of the Investment Company Act).

[66] Although these types of arrangements do not involve the conflicts posed by soft dollars, they do raise issues related to how a fund's assets are being expended and other issues, such as disclosure. *See* Concept Release at section VI.

[67] For a discussion of ''mixed-use'' items, see 1986 Release at section II.B and 2006 Release at section III.F. These releases stated, as an example of a product that may have a mixed use, management information services (which may integrate trading, execution, accounting, recordkeeping, and other administrative matters such as measuring the performance of accounts). In the 1986 Release, the Commission indicated that where a product has a mixed use, an investment adviser should make a reasonable allocation of the cost of the product according to its use, and should keep adequate books and records concerning the allocations. The Commission also stated: (i) That the allocation decision itself poses a conflict of interest for the investment adviser that should be disclosed to the client; and (ii) that an investment adviser may use client commissions pursuant to section 28(e) of the Exchange Act to pay for the portion of a service or specific component that assists the adviser in the investment decision-making process, but cannot use soft dollars to pay for that portion of a service that provides the adviser with administrative assistance. 1986 Release at Section II.B. The 2006 Release made clear that ''brokerage'' products and services, as defined in the release, may also require a mixed-use allocation. 2006 Release at nn.72–73. For a discussion of section 28(e) of the Exchange Act, see *infra* section III.C.

[68] Fund boards are not required to approve brokerage and research services simply because they fall within the section 28(e) safe harbor. Rather, board determinations regarding the purchase of brokerage and research services with fund brokerage commissions should be made in accordance with the fund's best interest. In this regard, section 28(e) contemplates that funds could enter into contracts to reduce or eliminate an adviser's ability to rely on the safe harbor. *See* Thomas P. Lemke & Gerald T. Lins, Soft Dollars and Other Brokerage Arrangements § 4.09 (2005) (''[T]he language of the safe harbor itself recognizes that the parties to an investment management relationship may by contract opt *out* of Section 28(e).''); *see also* Section 28(e) of the Exchange Act [15 U.S.C. 78bb(e)(1)] (stating that the safe harbor does not apply where ''expressly provided by contract'').

[69] 15 U.S.C. 78bb(e)(1). When fixed commission rates were abolished in 1975, investment advisers and broker-dealers expressed concern that, if an investment adviser were to cause a client account to pay more than the lowest commission rate available for a particular transaction, then the adviser would be exposed to charges that it had breached its fiduciary duty owed to its client. Congress addressed this concern by enacting section 28(e). *See* 2006 Release at section II.A.

[70] *See supra* note 63. It should be noted that section 28(e) of the Exchange Act does not encompass trades that are not executed on an agency basis, principal trades (with the exception of certain riskless principal transactions as described below), or other instruments traded net with no explicit commissions. *See* 2006 Release at n.27. However, the Commission has interpreted the term ''commission'' in section 28(e) as encompassing fees on certain riskless principal transactions that are reported under the trade reporting rules of the Financial Industry Regulatory Authority, or FINRA (as successor to the National Association of Securities Dealers, or NASD). *See Commission Guidance on the Scope of section 28(e) of the Exchange Act*, Exchange Act Release No. 45194 (Dec. 27, 2001) [67 FR 6 (Jan. 2, 2002)], at Section II.

[71] *See* 2006 Release at section III.

[72] *See supra* note 52 and accompanying text (discussing a fund board's obligation to approve an adviser's compliance policies and procedures).

[73] *See* 2006 Release at Section III.B.

[74] *See id.*

[75] *See* 2006 Release at n.150 and accompanying text (citing House Comm. on Interstate and Foreign Commerce, *Securities Reform Act of 1975 (H.R. 4111)*, H.R. Rep. No. 94–123, at 95 (1975) (''It is, of course, expected that money managers paying brokers an amount [of commissions] which is based upon the quality and reliability of the broker's services including the availability and value of research, would stand ready and be required to demonstrate that such expenditures were bona fide.'')); *see also* 1986 Release at Section IV.B.3 (explaining that, among the responsibilities of the disinterested directors of a fund may be to monitor the adviser's soft dollar arrangements).

the good faith determination required under section 28(e).

D. An Investment Adviser's General Fiduciary Obligations to Clients that Are Funds When Using Soft Dollars

As we have stated, although a fund adviser may satisfy the requirements for using client commissions to pay for brokerage and research services under the section 28(e) safe harbor, a fund's directors still should evaluate the adviser's use of fund brokerage commissions to purchase research and services in order to determine whether the adviser is acting in the best interest of the fund. If a fund board determines that the adviser's use of brokerage commissions is not in the best interest of the fund, the board should prohibit or limit the use of fund brokerage commissions and direct the adviser accordingly.[76]

In this regard, directors need to understand the procedures that the fund's investment adviser employs to address any potential conflicts of interest and ensure that fund commissions are being used appropriately. For example, to try to address concerns that a broker-dealer may be chosen by an adviser for reasons other than the quality of the broker-dealer's execution (including the brokerage and research services it provides), some advisers, particularly larger ones, may use an internal process referred to as a ''broker vote'' or ''broker tolls,'' whereby the adviser's investment professionals, typically the portfolio managers and investment analysts, assess the value of the research and services different broker-dealers provide to determine which broker-dealer's research and other services the adviser should purchase.[77]

To assist the board in understanding the adviser's policies and procedures regarding the use of fund brokerage commissions to obtain brokerage and research services, the board should request that the adviser inform the directors as to such matters as the following:

- How does the adviser determine the total amount of research to be obtained and how will the research actually be obtained? In particular:
- How does the adviser determine the amount to be spent using hard versus soft dollars?
- How does the adviser determine amounts to be spent on proprietary versus third-party research arrangements?
- What types of research products and services will the adviser seek to obtain and how will this research be beneficial to the fund?
- How does the adviser determine amounts to be used in commission recapture programs and expense reimbursement programs?
- What is the process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program? Is a broker vote process or some other mechanism used?
- Do any alternative trading venues that are used produce soft dollar credits? If so, how much?
- How does the adviser determine that the use of soft dollars is within the section 28(e) safe harbor? In particular:
- Is the product or service obtained eligible brokerage or research, as defined under section 28(e)?
- Does the product or service provide lawful and appropriate assistance to the adviser in carrying out its investment decision-making responsibilities?
- Is the amount of commissions paid reasonable (based upon a good faith determination) in light of the value of brokerage and research services provided by the broker-dealer?
- How does soft dollar usage compare to the adviser's total commission budget?
- How are soft dollar products and services allocated among the adviser's clients? Are the commissions paid for certain trades in fund portfolio securities similar to commissions paid for transactions in similar securities, or of similar sizes, by the fund and the adviser's other clients (including clients that are not funds)? Are other clients paying lower commissions that do not include a soft dollar component? If so, does the adviser adequately explain the discrepancy in commission rates and provide the board data sufficient to satisfy the board that the fund is not subsidizing the research needs of the adviser's other client? To what extent are the products and services purchased through soft dollar arrangements used for the benefit of fixed-income or other funds that generally do not pay brokerage commissions?
- What is the process for assessing the value of the products or services purchased with soft dollars?
- What is the process used to evaluate the portion of a mixed use product or service that can be paid for under section 28(e)?[78]
- To what extent does the adviser use client commission arrangements? What effect do these arrangements have on how the adviser selects a broker-dealer to complete a particular transaction? How does the adviser explain that the use of client commission arrangements benefits the fund?[79]

We request comment on the information boards should receive to facilitate their review of an adviser's use of soft dollars.[80] Should boards request any further information from advisers in this regard? Should boards employ any specific alternative approaches or analyses when reviewing an adviser's soft dollar usage? Is further guidance needed with respect to how a board should approach reviewing an adviser's soft dollar usage?

As with the adviser's trading practices, after receiving appropriate input and information from the adviser, if the board believes that the fund's brokerage commissions could be used differently so as to provide greater benefits to the fund, the board should direct the adviser accordingly. For example, the adviser should explain to the board that the value the fund receives from the brokerage and research services purchased with fund brokerage commissions is appropriate,

[76] *See supra* note 68 and accompanying text.

[77] Advisers have informed us that, although many employ a broker vote, the actual process of determining which brokers to use varies among firms, as do the factors upon which each firm's voting system is based. Often a system of rating or allocating points is used to set targets for each broker, with the better-rated brokers receiving additional orders. Other firms have substantially less formal broker-selection processes.

[78] As we stated in the 2006 Release, in allocating costs for a particular product or service, a money manager should make a good faith, fact-based analysis of how it and its employees use the product or service. It may be reasonable for an investment adviser to infer relative costs from relative benefits to the firm or its clients. Relevant factors might include, for example, the amount of time the product or service is used for eligible purposes versus non-eligible purposes, the relative utility (measured by objective metrics) to the firm of the eligible versus non-eligible uses, and the extent to which the product is redundant with other products employed by the firm for the same purpose. *See* 2006 Release at section III.F, n.148.

[79] We believe that the availability of electronic methods to order, track, and analyze securities trading may make it easier to determine whether client commission arrangements benefit a fund. With electronic trading, advisers and fund boards may be able to determine the costs associated with trade execution, as well as the expense of research paid for with fund brokerage commissions, with greater certainty. Also, to the extent that they incorporate transparency mechanisms such as the invoicing of costs for particular research products and services, the use of certain client commission arrangements may enable fund boards to more clearly determine the actual amount of commission dollars used to pay for research and those used to pay for execution.

[80] The staff has outlined some of the specific information fund boards have reviewed with respect to soft dollar arrangements. *See Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds*, Office of Compliance, Inspections and Examinations (Sept. 1998), available at *http://www.sec.gov/news/studies/softdolr.htm* (''1998 Staff Report''), at Appendix G.

and whether the services are inappropriately benefiting another of the adviser's clients at the fund's expense. In directing the adviser, the board also should consider such matters as: (i) Whether it is appropriate for the adviser to refrain from purchasing research services in connection with certain types of trades, depending on market conditions; (ii) whether it is appropriate for the adviser to use fund brokerage commissions to receive brokerage and research services on some or all trades; (iii) whether fund brokerage commissions should be used only in connection with a commission recapture or expense reimbursement program; and (iv) whether some combination of these alternatives may be in the best interest of the fund.

In addition, fund boards should inquire as to how the adviser's compliance policies and procedures with respect to soft dollars are determined and monitored.[81] In deciding whether to approve these policies and procedures, directors should consider, and the investment adviser should explain, how the policies and procedures eliminate or otherwise mitigate the conflicts of interest that exist when an adviser trades portfolio securities on the fund's behalf.[82] Furthermore, the value of research obtained through the use of soft dollars is a factor a fund board should consider when determining whether an investment adviser has fulfilled its best execution obligations.[83] The conflicts of interest inherent in soft dollar arrangements require boards to pay particular attention to investment advisers' activities in this regard to ensure that fund assets are being used appropriately on behalf of the fund.[84]

We request comment on our proposed guidance in regard to how a fund board should approach its review of an adviser's use of soft dollars and the adviser's applicable policies and procedures to ensure that the conflicts of interest inherent in these transactions are being managed.

E. Section 15(c) Under the Investment Company Act

In addition to their oversight and monitoring responsibilities with respect to portfolio trading and the conflicts of interest associated with soft dollar programs, fund directors have an obligation to review the adviser's compensation. This requirement stems from the requirement in section 15(c) of the Investment Company Act that the independent members of the board review the fund's investment advisory contract on an annual basis.[85] A fund board's review of the adviser's compensation under section 15(c) should incorporate consideration of soft dollar benefits that the adviser receives from fund brokerage.[86] In considering the advisory contract for approval, fund boards are required under section 15(c) to request and evaluate such information as may reasonably be necessary to evaluate the terms of the contract, and the adviser to the fund has the obligation to furnish to the board the information necessary to review the contract.[87]

Although fund boards typically review the use of fund brokerage by the adviser (including the adviser's use of soft dollars) during the contract review process, Commission examinations show wide variations in board practices in this area.[88] In many cases, fund boards are provided with Part II of the adviser's Form ADV. While Form ADV provides important information regarding the investment adviser, the Form ADV disclosure requirement was not designed for the purpose of providing fund directors with all of the information needed to help them satisfy board obligations under section 15(c) of the Investment Company Act. In order to fulfill their obligations in connection with the section 15(c) review process, fund boards often seek additional information on soft dollars. However, the types of additional information a board may require may vary depending on factors such as: (i) The scope and nature of the soft dollar program; (ii) the level of clarity and utility of the materials provided; (iii) the board's confidence in the adviser's relevant policies and procedures; and (iv) the adviser's compliance record. For example, information directors seek may range from simple reports on the cost of third-party soft dollar services to detailed reports on all fund portfolio securities transactions, including transaction volumes, soft dollar credits, services provided, and broker reviews.

To assist fund boards in carrying out their responsibilities under section 15(c), we believe it is appropriate for fund boards to request certain information regarding the adviser's use of fund brokerage, including soft dollar arrangements. Specifically, fund directors should require investment advisers, at a minimum, to provide them with information regarding the adviser's brokerage policies, and how a fund's brokerage commissions, and, in particular, the adviser's use of soft dollar commissions, were allocated, at least on an annual basis. Fund directors, in turn, should consider this information when they evaluate the terms of the advisory contract for the fund. Fund directors should, for example, consider whether the adviser properly accounts for use of fund brokerage commissions to purchase

[81] The Commission has stated that, in addition to an adviser's general best execution obligations, the compliance policies and procedures advisers are required to adopt and implement under rule 206(4)–7 of the Advisers Act should address the adviser's uses of client brokerage to obtain research and other services. *See* Compliance Release at Section II.

[82] In this regard, fund boards may look to, among other sources, the fund's CCO to provide assistance with evaluating any potential conflicts of interest with respect to the adviser's brokerage practices and determining how those conflicts should be addressed. *See* Compliance Release at section II.A.2.b.

[83] *See* 1986 Release at section V. An adviser should consider the full range and quality of the broker's services, including the value of research provided, in assessing whether a broker will provide best execution.

[84] As suggested above, failure by an investment adviser to disclose material conflicts of interest to its clients may constitute fraud within the meaning of sections 206(1) and (2) of the Advisers Act. *See supra* note 64. *See also Capital Gains*, 375 U.S. at 191–193, 200–01 (noting that ''suppression of information material to an evaluation of the disinterestedness of an investment adviser'' may operate ''as a deceit on purchasers.'').

[85] 15 U.S.C. 80a–15(c). Section 15(c) makes it unlawful for an investment company to enter into or renew an investment advisory contract unless it is approved by a majority of the company's disinterested directors.

[86] *See* 2006 Release; 1986 Release. In connection with the board's section 15(c) review of the advisory contract, section 36(b) of the Investment Company Act imposes a fiduciary duty on fund advisers with respect to their receipt of compensation for services or payments of a material nature from the fund or its shareholders. 15 U.S.C. 80a–36(b). In determining whether an adviser has breached its obligations under section 36(b), the seminal case of *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.,* 694 F.2d 923 (2d Cir. 1982), suggests that all of the facts and circumstances surrounding the adviser's relationship with the fund are appropriate for director consideration in approving the advisory contract. To the extent an adviser receives benefits from the use of soft dollars that are of ''sufficient substance,'' these benefits should be disclosed and considered by the fund's board of directors. *Id.* at 932–933 (stating that ''estimates of * * * 'fall-out' and 'float benefits' which, while not precise, could be a factor of sufficient substance to give the Funds' trustees a sound basis for negotiating a lower Manager's fee.'').

[87] Section 15(a)(1) of the Investment Company Act, which makes it unlawful for any person to serve as an investment adviser of a registered investment company except pursuant to a written contract which has been approved by a majority vote of shareholders and which ''precisely describes all compensation'' to be paid under that contract, also should be considered with regard to soft dollar arrangements. 15 U.S.C. 80a–15(a)(1). *See* 1986 Release at n.40.

[88] *See* 1998 Staff Report at 36. Examinations conducted since the 1998 Staff Report continue to document wide variations in the fund board review process. For example, our inspection staff has observed that, in certain cases, a fund board has not obtained the information necessary to evaluate soft dollar arrangements in the context of the board's section 15(c) review.

research that primarily or solely benefits another client of the adviser. We specifically ask for comment on the information that boards should request and that the adviser should provide in connection with the board's review of the advisory contract under section 15(c).

IV. Disclosure to Other Advisory Clients and Fund Investors

Our proposed guidance is designed to provide fund directors with information that will help them fulfill their oversight obligations with respect to the trading practices of the fund's investment adviser, including the adviser's use of soft dollars. The fact that the guidance is focused on fund boards should not be interpreted as an indication that the current level of soft dollar disclosure that is provided to other advisory clients and fund investors cannot be improved.[89] Accordingly, we solicit comment on whether we should propose additional disclosure requirements.

Currently, Part II of Form ADV, the adviser's firm brochure, must address the adviser's soft dollar practices. However, a 1998 report from our Office of Compliance Inspections and Examinations (''OCIE'') observed that advisers' disclosure often failed to provide sufficient information for clients or prospective clients to understand the advisers' soft dollar practices and the conflicts those practices present.[90] In its report, OCIE stated that most advisers' descriptions of soft dollar practices were boilerplate, and urged that we consider amending Form ADV to require better disclosure.[91] We sought to address this concern in our proposed amendments to Part 2 of Form ADV.[92] As currently proposed, Form ADV would require advisers to discuss the conflicts of interest inherent in an adviser's soft dollar practices and to describe the products and services acquired with soft dollars with enough specificity to permit clients to evaluate the conflicts of interest involved.[93]

The guidance we are proposing today reflects the Commission's view of the critical role fund boards play in managing the adviser's conflicts of interest. We request general comment on our proposed guidance. In addition, we specifically request comment on whether: (i) Further disclosure to fund investors of the information we suggest fund boards should 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 a fund adviser's portfolio trading practices would have an adverse impact on the fund adviser's relationships with the broker-dealers that execute fund portfolio transactions.

We also request comment on whether we should again consider proposing to require investment advisers to provide their clients with customized information about how their individual brokerage is being used. If so, what types of information would be useful and in what detail? Should the information provided be different for institutional and non-institutional clients? Do institutional clients already require their advisers to provide information to them about soft dollars on a regular basis, and if so, what kind of information do they receive? What are the cost implications of requiring individual client reports?

V. Solicitation of Additional Comments

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to fund board oversight of advisers' portfolio trading practices. Please be as specific as possible in your discussion and analysis of any additional issues.

By the Commission.

Dated: July 30, 2008.

Florence E. Harmon,

Acting Secretary.

[FR Doc. E8–18035 Filed 8–5–08; 8:45 am]

BILLING CODE 8010–01–P

[89] We have considered enhancing soft dollar disclosure requirements in the past. For example, the Commission proposed a rule in 1995 that would have required an adviser to provide its clients with an annual report setting forth certain information about the adviser's use of client brokerage and the soft dollar services received by the adviser. The report would have included certain quantitative information about brokerage allocation and commissions paid. *See Disclosure by Investment Advisers Regarding Soft Dollar Practices*, Investment Advisers Act Release No. 1469 (Feb. 14, 1995) [60 FR 9750 (Feb. 21, 1995)].

[90] *See* 1998 Staff Report.

[91] *Id.*

[92] *See Amendments to Form ADV,* Investment Advisers Act Release No. 2711 (March 3, 2008) [73 FR 13958 (March 14, 2008)]. As proposed, Item 12 of Part 2 would require an adviser that receives soft dollar products and services to disclose its practices and to discuss the conflicts of interest they create. Specifically, Part 2 would require an adviser to disclose to clients: (i) That it receives a benefit because it does not have to produce or pay for the products and services; (ii) that it has an incentive to select broker-dealers based on its interests instead of clients' interests in receiving best execution; (iii) whether or not it pays-up for soft dollar benefits; (iv) whether soft dollar benefits are used to service all of its accounts or just the accounts that paid for the benefits; and (v) the products and services it receives, describing them with enough specificity for clients to understand and evaluate possible conflicts of interest.

[93] *Id.*

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–102822–08]

RIN 1545–BH54

Section 108 Reduction of Tax Attributes for S Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance on the manner in which an S corporation reduces its tax attributes under section 108(b) for taxable years in which the S corporation has discharge of indebtedness income that is excluded from gross income under section 108(a). In particular, the regulations address situations in which the aggregate amount of the shareholders' disallowed section 1366(d) losses and deductions that are treated as a net operating loss tax attribute of the S corporation exceeds the amount of the S corporation's excluded discharge of indebtedness income. The proposed regulations will affect S corporations and their shareholders. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by November 4, 2008. Outlines of topics to be discussed at the public hearing scheduled for December 8, 2008, must be received by November 4, 2008.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–102822–08), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–102822–08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov/* (IRS REG–102822–08). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.