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SEC Proposes Soft-Dollar Guidance for Fund Boards

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The Securities and Exchange Commission has issued proposed guidelines to help mutual fund boards in their oversight of investment advisers who pay for services using soft-dollar commissions.

The guidance, which would not impose new requirements on the fund boards or advisers, would complement the commission's 2006 interpretive guidance on the services investment advisers can pay for with soft dollars.

Approved unanimously July 30, the new guidance includes information that a board should request from advisers to determine whether they are managing potential conflicts of interest in the use of soft dollars versus a broker's obligation to seek best execution.

"Fund boards play a pivotal role in monitoring the conflicts of interest that may arise when an investment adviser trades a fund's portfolio securities," said Andrew Donohue, director of the SEC's division of investment management, in a prepared statement. "The importance of the board's responsibilities in this area cannot be overstated."

The Mutual Fund Directors Forum (MFDF), a Washington, D.C.-based association of independent fund directors, welcomed the guidelines. "Most notable is the recognition of the central role that fund directors play in overseeing the use of soft dollars," said David Smith, executive vice president of the MFDF. "This is not an algorithmic approach. It gives directors a reasonable amount of flexibility in coming to their own conclusions. This is an issue that directors spend a lot of time on."

"This is good for the market," added Kristi Wetherington, CEO of agency brokerage Capital Institutional Services in Dallas. "You can never argue against additional disclosure or guidance. It gives directors a flexible framework in which to monitor the activities of investment advisers."

The SEC in its guidance memorandum cited several types of conflicts that can arise when advisers use soft dollars, including trading a fund's portfolio specifically to earn soft-dollar credits; selecting a broker-dealer on the basis of research services rather than ability to provide best execution; and using research to benefit the advisers' other clients, including those that do not generate brokerage commissions, such as fixed-income funds.

"A fund board should request that the fund adviser inform directors of the policies and procedures the fund adviser uses to ensure that the type of brokerage and research services the adviser obtains [using soft dollars] fall within the safe harbor, and that the adviser has not engaged in excessive trading in light of the fund's investment objectives," said the SEC. The so-called safe-harbor provision, a 1975 amendment to the Securities Exchange Act of 1934, provides the parameters for the appropriate use of soft dollars by the advisers.

In its proposed guidelines, the SEC suggested that boards ask advisers to tell them how they determine the total amount of research obtained and how they receive it; the amount they spend using soft and hard dollars and on proprietary versus third-party research; the types of research they procure and how it benefits the fund; and the sums involved in commission-recapture and expense-reimbursement programs.

The agency also said fund boards need to question advisers about the process they use to establish a soft-dollar research budget, alternative trading venues used to produce soft-dollar credits, and how soft-dollar products and services are allocated among their clients.

"The conflicts of interest inherent in soft-dollar arrangements require boards to pay particular attention to investment advisers' activities ... to ensure that fund assets are being used appropriately on behalf of the fund," the agency added.

The proposal, published in the Aug. 6 Federal Register, will be open for comment until Oct. 1, when the SEC will evaluate the responses and issue final guidance.