CFA INSTITUTE
Centre for Financial Market Integrity

October 6, 2008

Ms. Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-9303

RE: File No. S7-22-08
Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices

Dear Ms. Harmon:

The CFA Centre for Financial Market Integrity (CFA Centre)[1] appreciates the opportunity to comment on the SEC's release providing guidance regarding the duties and responsibilities of investment company boards of directors with respect to investment adviser portfolio trading practices.

The CFA Centre supports the Commission's efforts to detail the information that will assist fund directors in overseeing the trading activity of the fund's advisors. Although soft-dollar practices are subject to abuse, CFA Centre believes that soft dollars play an important role in providing information and research to the global capital markets and the conflicts inherent in soft-dollar arrangements can be effectively addressed through adequate disclosure. The specific information set forth in the Commission's release will provide valuable and essential information to fund directors to ensure advisors use trading commissions appropriately. Funds should provide this information not only to directors but make it generally available to fund investors, as well. The Commission should also consider requiring investment advisers in general to disclose to clients detailed information about their use of client commissions.

Current State of the Soft-Dollar Debate

The industry currently is in a state of transition regarding soft-dollar practices.

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

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Some investment managers are reluctant to move away from the current model of soft-dollar-funded research as they are able to pass through the cost of paying for research expenses to their clients. Supporters of the soft-dollar model believe that if research providers are no longer funded by soft dollars, there will be a significant reduction in the amount of research that is available to investment managers because managers will be unwilling to pay for research in hard dollars. Unbundling the cost of trading from the cost of the services and research purchased by the commissions would increase the administrative expense of tracking payments for research. They argue that paying hard dollars for research would lead to increased costs to the investment managers which would lead to either increased fees for the investors or reduced profit for the managers.

But others believe that research costs are a firm expense that should be paid for by the firm rather than by clients through higher commissions. The research products and services received through soft dollars are a “cost of doing business” that shouldn’t be paid for by client commissions. Unbundling leads to transparency of fees for the investor. If broker-dealers are forced to unbundle the cost of research from their trading commissions, investors would be able to determine what services their commissions are paying for. This would force full-service brokers to evaluate their proprietary research and lead to a highly competitive, free-market approach to investment research. This would eliminate demand for low-quality research and encourage real, independent, high-quality research that is useful to investment managers. Unbundling would force trading commissions to decrease and lead to consolidation of execution as investment managers send more of their trading business to the lower-cost "unbundled" platforms.

Certain large US investment managers have negotiated the unbundling of commissions, and are paying for research with cash rather than soft dollars. This has forced their brokers to break out execution and research fees and to affix a value to each of its research products. This action has established a model where money managers pay for proprietary research separately from execution.

The actions by large investment firms to eliminate their soft-dollar practices, the negative investor perception of soft-dollar arrangements, continued regulatory pressure, and the publicity surrounding the conflict of interest and lack of transparency issues of this practice may ultimately make it difficult for the investment industry to continue current soft-dollar practices.

Benefits of Soft-Dollar Arrangements

One of the founding principles of CFA Institute is to promote the dissemination of information, through thorough and intellectually rigorous securities analysis, to the global capital markets. The interests of investors are best served by making a wide variety of such research available to the markets.

Soft-dollar arrangements encourage the publication of research that provides money managers and investors with a broad range of information and analysis of securities. The extensive amount of securities research, promoted by this long-standing industry practice, can:

- increase investor confidence and participation in securities markets,
- facilitate the efficient allocation of investment capital,
- encourage better corporate disclosure, and
- facilitate the effective management of client accounts.

While there are inherent conflicts of interest in soft-dollar arrangements, CFA Centre believes that options for investors to obtain investment or research services should not be limited. Soft-dollar arrangements help make it possible for clients of smaller money management firms, who may not be able to profitably support an extensive in-house research effort or pay hard dollars for research, to benefit from research provided to their money managers. Without soft dollars, modestly-sized money managers and independent research firms that have grown up and thrived under the practice may be forced out of the investment industry.

While soft dollars may benefit investors and the market by encouraging research, such arrangements clearly are subject to abuse. The commissions used by managers to pay for soft-dollar research are the property of their clients. To meet their fiduciary responsibilities to their clients, managers must use the soft-dollar credits generated by trading commissions only for research services that benefit their clients.

Rather than attempt to address these conflicts by eliminating soft-dollar practices, thereby possibly threatening the amount of information, analysis, and research available to investors, the CFA Centre believes that conflicts of interest can be effectively addressed by 1) strictly limiting the products and services available through soft-dollar arrangements to "research" that primarily benefit investors, and 2) increased disclosure regarding soft-dollar practices to investors.

CFA Institute Soft Dollar Standards

In 1999, CFA Institute (then the Association for Investment Management and Research) issued its *Soft Dollar Standards – Guidance for Ethical Practices Involving Client Brokerage*. The Soft Dollar Standards provide guidance to investment professionals world-wide through the articulation of high ethical standards that are consistent with and complement the CFA Institute *Code of Ethics* and *Standards of Professional Conduct* that all CFA Institute members and candidates for the CFA designation are required to follow.

The CFA Institute Soft Dollar Standards are founded upon the core principle that brokerage commissions belong to the client. As a result, client commissions must be spent in the client's best interest. The Standards create a framework that restricts the use of client commissions in soft or bundled arrangements to the acquisition of research and/or brokerage services. One critical component of these standards is a narrow "use-based" definition of "research" that reflects a more restrictive view of research than current SEC interpretation. The Standards define research as services and/or products that directly assist the investment manager in the investment decision-making process and not in the management of the firm.

Furthermore, the Standards require transparency via regular client reporting on how the client's commissions have been spent. The Standards require that an investment manager must clearly disclose with specificity and in "plain language" its policies with respect to all soft-dollar arrangements. Specifically, the Standards required investment mangers to disclose to clients and potential clients (i) the types of research received through proprietary or third-party research arrangements, (ii) the extent of use, and (iii) whether any affiliated broker is involved. For each specific client, the Standards mandate disclosure of the total amount of commissions subject to soft-dollar arrangement generated for the client, detailed by broker, and recommend that the investment adviser provide a description of the product or service obtained through brokerage generated from the client's account.

CFA Centre's Prior Comment to the SEC on Soft Dollar Disclosure

In 2006, the Centre expressed support for the Commission's efforts to narrow the scope of products and services covered by the safe harbor of Section 28(e) to research, reports, and analyses that lawfully and appropriately assist the money manger in the performance of their investment decision-making responsibilities. However, we noted then that adopting a narrow definition of research was only one part of protecting client interests in their managers' use of soft dollars.

Earlier this year, in offering comments on the Commission's proposed amendments to Form ADV we strongly supported the proposed disclosure relating to soft-dollar arrangements and suggested several additional areas that should be addressed. Additional disclosure included a reasonable estimate from the adviser of the percentage of the dollar amount of its soft-dollar arrangements compared to the total dollar amount of all brokerage commissions paid on a yearly basis. By receiving this information, an investor will be better able to assess the degree to which the adviser is engaging in soft-dollar arrangements and assess the potential effect on the adviser's duty to seek best execution. This disclosure may also raise questions in the minds of clients about the degree to which their accounts may be "subsidizing" others.

If investors are given a description of the products and services and their cost, they can determine whether they want to buy those services. Disclosure allows investors to make informed decisions about whether they are receiving a benefit from the soft-dollar research obtained by their adviser, how much they are paying for the service, and whether to use advisers who enter into soft-dollar arrangements.

The CFA Centre recommends that advisers using soft dollars to make sufficient disclosure to answer the following questions for investors:

i. *Does the firm participate in soft-dollar arrangements?*

- Whether the firm obtains third-party or proprietary research through soft dollars or bundled brokerage.

ii. *Who do advisers receive research services from?*
- List of brokers used (is the broker affiliated?) (by client and on firm-wide basis);
- List of brokers providing soft dollars (by client and on a firm-wide basis).

iii. *What research services are advisers receiving?*
- Description of services received (on firm-wide basis);
- List of services received from each broker (on firm-wide basis).

iv. *What is the cost of those services?*
- Total commissions by broker (on firm-wide basis);
- Total commissions paid and total for broker (by client);
- Average commission per share by broker;
- Average commission rate for brokers providing soft-dollar services v. those that do not.

<u>Guidance to Investment Fund Directors</u>

As the Commission points out in its release, fund boards have a legal and fiduciary duty to protect the interests of the investors in the funds by thoroughly reviewing the practices of the fund adviser to ensure they are acting in the best interests of investors. This includes reviewing the policies, procedures, and practices of the fund with respect to soft dollars.

The Centre agrees with the Commission that it is imperative that fund directors understand and scrutinize the fund transaction costs to ensure that the payment benefits the clients and does not pay for services that benefit the fund's adviser that should be paid directly by the adviser. The fund's board should be sufficiently familiar with the adviser's trading practices to satisfy itself that the adviser is acting in the best interests of the fund.

The guidance set forth by the commission gives appropriate direction to fund boards with respect to the information they should be seeking from advisers regarding their soft-dollar practices. We concur with the Commission that while no new requirements are imposed, the guidance greatly increases the amount of information a fund board receives from its adviser with regards to soft dollars.

The objections to soft-dollar practices arise in large measure from the lack of disclosure provided to investors. With full disclosure comes transparency. Fund boards can review the research and services purchased by the adviser for the fund by asking the questions set forth in the proposed guidance. Fund boards with complete information about the soft-dollar practices of their advisors can make informed decisions about whether their advisers are using these arrangements appropriately and whether the value of the services they receive is supported by the commissions paid.

Disclosure to Investors

The CFA Centre is dedicated the fundamental ethical principle of full and fair disclosure to investors. Only through clear, effective, and regular communication can investors understand how investment advisers are acting on their behalf and make well-informed decisions about how and with whom to invest their assets.

The information disclosures relating to best execution and soft dollars that the Commission is proposing fund boards request is also valuable information to investors in the funds. The Centre believes that such information should not be limited to fund boards but should also be disseminated to investors in those funds. Investors can evaluate for themselves whether the best execution and soft-dollar practices of the advisor are in the investors best interest. With knowledge of these practices, investors can make informed decisions about whether to make an investment in a particular fund.

The Centre also believes that the type of information outlined in the guidance directed to fund boards would be beneficial to all investors using advisers engaged in soft-dollar practices. The Centre encourages the Commission to broaden the scope of the guidance or enact additional guidance directing all invest advisors using soft dollars to provide this information to their clients.

Conclusion

We believe it is important for investors to know the potential conflicts of interest inherent in an adviser engaging in soft-dollar arrangements relating to either proprietary or third-party research, and to know how those conflicts are managed. CFA Centre believes that full and fair disclosure by managers regarding their soft-dollar practices is a critical step managers must take to meet their fiduciary duties. For some time, CFA Institute, through the Soft Dollars Standards, has called on industry participants to make such disclosure.

The Centre supports the proposed guidance to fund boards directing them to request more elaborate and detailed information from their advisor regarding soft-dollar and best-execution practices. The Centre believes that this information would benefit investors in the fund and believes similar information should be provided by investment advisors generally to their clients.

Respectfully,

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