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February 17, 2009

The Honorable Mary L. Schapiro
Chairman
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Chairman Schapiro:

The Committee on Investment Management Regulation of the Association of the Bar of the City of New York is composed of lawyers with diverse perspectives on investment management issues, including members of law firms, and counsel to a variety of financial services firms, such as investment company complexes, private funds, broker-dealers, and investment advisers. A list of our current members is attached as Annex A.

Congratulations on your appointment as Chairman of the Securities and Exchange Commission. We look forward to the opportunity to work with you as you take leadership of the SEC at a crucial time, both in its own history and that of the financial services industry.

As you may be aware, the Committee, together with other committees of the Association of the Bar, submitted a statement to then President-Elect Obama's Transition Team Regarding Regulation of Financial Services ("Statement to the Transition Team") containing several recommendations for improving the regulatory structure of the financial services industry in the United States.[1] We are writing today to reiterate some of those recommendations and to present others that, in our view, are particularly relevant to the investment management industry. We respectfully request that you consider the following as you develop your forthcoming agenda for the SEC.

Regulatory reform and coordination among financial regulators. At your nomination hearing before the Senate Committee on Banking, Housing and Urban Affairs, you explained that there are many reasons for the financial crisis facing our nation, including that "our regulatory system has not kept pace with the markets and the needs of investors." We expressed a similar sentiment in the Statement to the Transition Team, where we said that the U.S. regulatory system was not designed to deal with the dynamic growth the financial services industry has experienced over the past 80 years. Decentralization and segregation of oversight responsibilities over an increasingly complex financial services industry, without a comprehensive framework for coordination among financial regulators, appears to have led to gaps in regulation and may have contributed significantly to the magnitude, and perhaps to the causes, of the financial crisis.

We encourage you to work with Congress and other financial regulators to develop a comprehensive framework for regulatory cooperation that will keep pace with the markets and investor needs. In arriving at such a framework, we also encourage you to consider a harmonized approach to the regulation of financial products and services, an approach that should evolve from one based on form to one based on economic substance (*e.g.*, swaps, forwards, and futures should be overseen by the same regulator applying the same principles).

Regulation of product distribution and creation also should be handled in a coordinated fashion, ideally by the same regulator, with the goal of avoiding both regulatory gaps and redundancies. In our view, such an approach would enable regulators to better understand the underlying

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1 A copy of the Statement to the Transition Team is attached as Annex B.

economics (including tax implications) of a product and its distribution, and better address risks to the financial system, as well as address sales practices, valuation, and other issues that are important to investor protection.

The approach also should take into account the ever-increasing global nature of the financial services industry. This may require a more systematic approach to coordination with global financial regulators than what we understand historically has been the case. It is our understanding that global coordination has consisted primarily of ad hoc establishment of memoranda of understanding, cooperation on investigations and enforcement actions from time to time, and periodic meetings of the International Organization of Securities Commissions. Given the worldwide scope of the current economic crisis, we encourage you to initiate discussions regarding potential coordination of regulations, capital standards, and oversight, perhaps through a structure similar to the President's Working Group.

SEC resources. As was discussed in the Statement to the Transition Team, we believe that regulation of the securities industry should maintain the essential balance between protecting consumers and investors, on the one hand, and encouraging investment and capital formation, on the other. This is consistent with Section 2(c) of the Investment Company Act of 1940, as well as the mission of the SEC, which is both to protect investors and to maintain fair, orderly, and efficient markets and to facilitate capital formation.[2]

The Committee believes there are opportunities for increasing the SEC's ability to more effectively pursue investment fraud and other serious securities law violations, thereby protecting investors, while also promoting the efficient functioning of the capital markets. For example, we support your efforts to refocus the SEC's examination program for investment advisers, mutual funds, and broker-dealers in such a way as to increase its efforts at identifying securities fraud and other serious securities law violations. In that regard, we question whether having the examination staff in a separate office is the optimal use of SEC resources. We suggest that

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2 Section 2(c) of the Investment Company Act states that whenever the SEC is engaged in rulemaking and is required to consider or determine whether an action is consistent with the public interest, the SEC also must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

consideration be given to moving the examination staff into the Divisions of Investment Management and Trading and Markets to better coordinate and inform policy-making, risk assessment, and disclosure.

You and others have spoken recently about the critical need of the SEC to be able to attract and retain highly qualified and motivated individuals. In doing so, knowledge of business and how businesses develop over time, a knowledge that evolves and is not static, should be a focus for the SEC and for other regulators. To increase flexibility in recruiting, retaining, and training highly qualified and knowledgeable professionals, you might consider requesting the authority to adopt an independent funding model based on the receipt of filing fees or other similar user fees. An independent funding model has been successfully used in the bank regulatory area and could enhance the ability of the SEC to make the examination program and other programs more robust.

Industry Outreach. The SEC also could increase its effectiveness by encouraging securities industry participants to provide more transparency regarding their financial positions and new business activities. This could be accomplished as part of a new regulatory framework or as part of an initiative to encourage sharing such information on a more routine basis. For its part, the SEC's staff already has begun to expand its efforts at sharing information by, for example, publishing a list of the core set of records examiners request from advisers they are reviewing, publishing "compliance alerts" that highlight and explain some of the results of recent examinations, and hosting outreach events and meetings with chief compliance officers and fund directors. The Committee encourages the expansion of such efforts, which might include posting examination lists or modules as other financial regulatory agencies do. These kinds of initiatives generally have been well received. They enhance the flow of information between the industry and the regulators, increase the level of understanding of industry participants and regulators, and serve to increase the industry-wide culture of compliance.

Exemptive Application Process. Another opportunity for improving efficiency, including in respect of the development of innovative new financial products that are important to both investors and the industry, would be to improve the efficiency in processing applications for exemptive orders submitted to the Division of Investment Management (as well as other

Divisions) and in accelerating the process of proposing and adopting rules codifying the substance of frequently granted exemptive orders. This has been a stated priority of the current Director, as well as past Directors, of that Division and we strongly support the goal of improving efficiency in this area.

The SEC also should build upon its existing efforts to provide less formal forms of interpretive guidance through the issuance of no action letters and staff interpretations. Given fast-moving markets and continued volatility, it is critical that market participants have a channel through which to obtain regulatory guidance on a real-time or accelerated basis. In this regard, we commend the staff of the Division of Investment Management in particular for their responsiveness in providing timely guidance in respect of numerous issues relating to money market funds as a result of the severe market disruptions of recent times, and we encourage similar efforts in the future.

Responsibilities of fund directors. An area that is of central importance to the investment management industry is the role of fund directors generally, and independent fund directors in particular. As you know, the purpose of the Investment Company Act is to protect investors, especially with regard to conflicts that may exist between the interests of fund shareholders and management. It has long been understood that the independent directors of investment companies stand at the core of that Act. The Supreme Court has referred to the independent directors as the "independent watchdogs" and the SEC has consistently recognized the important and unique role played by the independent directors of investment companies. The function of independent directors in the investment company arena has long been viewed as critical because of the relationships that exist between a fund and the entities that created it, resulting in inherent conflicts of interest and potential for abuse.

The Committee respectfully encourages you to direct the staff to look into ways to increase fund directors' effectiveness at carrying out their fundamental oversight responsibilities by reducing the often time-consuming and overlapping requirements that are not central to their function of

overseeing conflicts.[3] Many fund directors believe that too much of their time at board meetings is spent on routine compliance work or making required findings that can only be made, as a practical matter, in reliance on representations by an expert third party such as the fund's adviser or administrator. The ability of fund directors to exercise their oversight responsibilities is hindered to the extent they must devote significant attention to these types of matters.

In a December 20, 2007, letter submitted to the Director of the Division of Investment Management (attached as Annex C) recommending various actions the SEC or its staff might consider to improve directors' effectiveness, we stated that protection of shareholders would be enhanced by permitting compliance monitoring and expert determination responsibilities to be undertaken by others. For example, it makes most sense, in our view, to permit a fund's directors to satisfy their quarterly transaction review obligations under various exemptive rules and orders by receiving quarterly reports from the fund's chief compliance officer in lieu of receiving reports on each individual transaction. In the case of certain expert determinations, the responsibility should be re-assigned from fund directors to the fund adviser or some other person with the appropriate expert capability. We respectfully reiterate our view that shareholder interests are enhanced by permitting directors to focus more of their attention on matters that they believe are important in discharging their duties to the funds. In addition, the Committee reiterates its recommendation that the SEC act expediently upon the recently proposed guidance to fund directors regarding investment adviser portfolio trading practices in order to clarify directors' responsibilities in that area. In finalizing that guidance, the Committee urges you to consider the comments it submitted, which are attached as Annex D.

Money market funds. The Committee believes that a review of the regulations that apply to money market mutual funds should be high on your agenda. Today, money market fund assets

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3 In a recent speech, Andrew J. Donohue, the Director of the Division of Investment Management, also indicated that there may be opportunities to reduce the burdens on independent directors to permit them to focus their attention and resources on those matters most critical to their mission to oversee conflicts. Andrew J. Donohue, *Address at the Mutual Fund Directors Forum Third Annual Directors' Institute* (Jan. 13, 2009). The Committee acknowledges the recent efforts of the Division in this area. Under Mr. Donohue's leadership, the Division has established a "Director Outreach Initiative" with the twin goals of gaining a better understanding of how directors (in particular independent directors) discharge their current responsibilities and, where effectiveness could be enhanced by rule changes, making recommendations to the SEC for rule proposals to increase that effectiveness. The Committee strongly supports this and similar initiatives.

total almost $4 trillion and these funds play a complex but critical role in our markets, including providing a major source of short-term financing and liquidity to the capital markets while being viewed as a safe-haven for savings.[4] Prior to making substantial changes to the regulation of money market funds, we encourage you to establish a task force, which should include risk assessment personnel and, if possible, business persons who understand the roles money market funds play in the capital markets and in mutual fund investor portfolios and who also understand the implications of any regulatory changes for the capital markets, mutual fund investors, and fund complexes.[5] The task force could consider and, if appropriate, recommend changes to the existing regulatory structure of this multi-trillion dollar industry, including consideration of the need for insurance to be provided by a federal agency or the private sector.

Regulation of broker-dealers and investment advisers. We understand that an area that is particularly important to you is the regulatory structure applicable to broker-dealers and investment advisers. We believe that the same fair dealing standards should apply to broker-dealers and investment advisers, commensurate with the responsibilities contracted for with the respective client.[6] Any changes to the regulatory framework should include protections against abuses arising from conflicts of interest, subject to exceptions or exemptions that would be consistent with investor protection and efficient markets (*e.g.*, blanket customer consent to principal trades would be recognized).

Rule 12b-1 reform. We understand that the Division of Investment Management may consider making a recommendation to you to amend Rule 12b-1 under the Investment Company Act. The Committee believes that an issue that warrants consideration is the role of a fund's directors regarding the approval and continuance of the fund's Rule 12b-1 plan. Consistent with the discussion above regarding enhancing directors' effectiveness, the experience of the members of

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4 Investment Company Institute, *Money Market Mutual Fund Assets* (Feb. 5, 2009) (as of February 4, 2009, total money market mutual fund assets were $3.906 trillion).

5 In its recent paper, *Financial Reform, A Framework for Financial Stability* (Jan. 15, 2009), the Working Group on Financial Reform of the Group of Thirty recommended significant changes to the regulation and structure of money market funds.

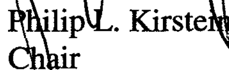
6 Such an approach would, in our view, address the investor confusion found by the RAND Corporation in its study of the role of investment advisers and broker-dealers and how the nature of their relationships with investors differs. RAND Corp., *Investor and Industry Perspectives on Investment Advisers and Broker-Dealers* (Mar. 19, 2008).

the Committee suggests that the existing guidance regarding boards' considerations when evaluating whether to approve or continue a Rule 12b-1 plan is outdated and not consistent with current practices or the marketplace realities of 12b-1 plans. Senior members of the Division of Investment Management have acknowledged this for many years. Other, more fundamental changes to Rule 12b-1, such as "externalizing" 12b-1 fees or requiring the elimination of certain currently existing share class structures, raise not just legal, but also significant business, operational, and tax issues that are difficult to overstate. We recognize your familiarity with the long-standing debate regarding these issues given your substantial experience, and we respectfully submit that the more appropriate reform of Rule 12b-1 would be to update the SEC's guidance to fund directors regarding the factors in considering the approval or continuance of 12b-1 plans.

Conclusion

The Committee would welcome the opportunity to discuss with you any or all of the forgoing, and to collaborate with your staff as they work through these important issues. Please do not hesitate to contact the undersigned by telephone at (212) 969-2108 or by e-mail at phil.kirstein@alliancebernstein.com.

Very truly yours,



Philip L. Kirstein
Chair

Attachments

cc: Andrew J. Donohue
Director, Division of Investment Management

The Association of the Bar of The City of New York
Committee on Investment Management Regulation

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Statement to Economic and International Trade Transition Team Regarding Regulation of Financial Services

The Association of the Bar of the City of New York

December, 2008

Although the government has not yet commissioned a comprehensive study into the factors that led to the current economic crisis, regulatory failures are seen to have contributed significantly to the magnitude, and perhaps to the cause, of the crisis in the U.S. Decentralization and segregation of oversight responsibilities among a number of different regulators, without a framework for coordination among them, led to gaps in regulation. Duplicative and inefficient regulation and competition among regulators served as incentives to financial services providers to move their businesses abroad and to structure products and services in a manner so as to avoid U.S. regulation.

Financial products and services provided to U.S. retail investors and consumers are overseen by multiple regulators imposing overlapping requirements, based on outdated rules that were established largely in the 1930s and 1940s. In contrast, products and services provided to institutional investors are often not subject to any regulatory reporting and structured in such complex ways that it is difficult for regulators and investors to understand the systemic and investor risks that the products present. In general, the U.S. regulatory system was not designed to deal with the dynamic growth of the financial services industry has experienced over the past 80 years and, as currently structured, is not well-positioned to address the challenges facing our marketplace both at present and in the future.

The depth of the crisis provides an opportunity to look at regulation of financial services in a new way and address the problems that led to deterioration of the current system. As the Obama Administration begins its evaluation of the current financial regulatory framework, the Association of the Bar of the City of New York urges the Obama Administration to seek a new model for regulation of financial services and markets which ensures that the U.S. will continue to be the strongest, most important capital market in the world.

The Association of the Bar, founded in 1870, has over 23,000 members. While most practice law in the New York area, the Association's membership includes lawyers from around the nation and in 50 foreign countries. The Association regularly reports on legislative and regulatory issues with regard to the financial sector.

In the hope that this Association can be of assistance in helping the Administration to think through a new approach, 10 of the Association's committees that address financial services issues and related fields have developed the following recommendations for the Administration to consider.

Regulatory Structure

1. *Regulation Based on Substance.* The regulatory approach should evolve from one based on form to one based on economic substance (e.g., swaps, forwards and futures should be overseen by the same regulator applying the same principles). Regulation of product distribution and creation would also be handled in a coordinated fashion, with the goal of avoiding gaps and redundancies contained in the current structure, which have led to the breakdown of regulatory oversight in a number of areas. Such an approach would encourage regulators to understand better the underlying economics of a product and its distribution, address valuation issues and, thereby, design an appropriate regulatory framework.

2. *Consolidation of Regulation and Centralization in a Federal Forum.* Consideration should be given to consolidating regulatory responsibilities into fewer federal agencies, to gain efficiencies and in recognition of the overlap of financial services and the integration of financial services companies. Given the increasing national and global aspect of the financial sector, consideration should be given to whether effective federal regulation would be a better approach than state-by-state regulation in the financial services area. The new structure should ensure that regulators have sufficient funding as well as appropriate independent oversight.

3. *Enhancing Disclosure and Transparency.* Any new regulatory paradigm should include an improved approach to disclosure and transparency which would feature:

a. More user-friendly disclosure to consumers, including disclosure of potential risk, so they can better grasp the risk/reward balance and other implications of the various financial products they are considering. Such an approach might well include consumer acknowledgement of that disclosure before purchase of the relevant financial product;

b. Enhanced reporting requirements for all products, to provide greater insight into the marketplace and transactions for investing professionals and the regulators;

c. Leveraging of available technology to deliver information efficiently and quickly, acknowledging the importance of the new speed of communication.

4. *Best Practices and Improved Communications Between Industry and Regulators.* In formulating the regulatory framework and regulating specific functions, the various financial industries should be brought into the process from the initial stages. Industries should be encouraged to advance "best practices" and make other recommendations in a continuing dialogue. We believe the regulations will be more effective with such collaboration, and those being regulated would better understand what is expected of them. The new paradigm would create a more cooperative relationship between the regulators themselves (both globally and in the U.S.) and between the regulators and the industry and enhance the flow of information between the industry and the regulators.

Regulatory Guideposts

Regulation of the financial sector should maintain the essential balance between protecting consumers and investors, on the one hand, and encouraging investment and capital formation on the other. The regulatory framework should promote efficiency, encourage innovation and promote stability in financing and investment.

Global Perspective

Regulation in the United States must be undertaken with an understanding of the increasingly global scope of the financial sector. The U.S. cannot attempt to regulate in a vacuum. This country should not risk losing its regulatory effectiveness or its role as the pre-eminent financial center by driving financial services firms and investors overseas and thus further from our regulatory reach. Nor should a new regulatory paradigm result in a sacrifice of disclosure, accounting and other standards that resulted in the historic preeminence of the United States financial markets. It is important to establish a framework within which regulators in the U.S. and abroad coordinate their enforcement and regulatory programs. This requires a more systematic approach than the current ad hoc establishment of memoranda of understanding by the SEC with foreign regulators and periodic meetings of the International Organization of Securities Commissions. The worldwide economic crisis should prompt international discussions regarding coordination of regulations and oversight (perhaps through a structure similar to the President's Working Group) as well as creation of uniform standards, such as adoption of international accounting standards, and frameworks to facilitate offering of cross-border products and services.

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In addition to these general recommendations, a number of Association committees put forth the following recommendations for your consideration regarding specific aspects of financial regulation:

- *Integrated Regulation of Broker-Dealers and Investment Advisers.*
  The same fair dealing standards would apply to broker-dealers and investment advisers, commensurate with the responsibilities contracted for with the client. Regulation would not change based upon the form of compensation or whether the advice is "incidental" to brokerage. The regulatory framework would include protections against abuses arising from conflicts of interest, including principal trades with an adviser or an affiliate, subject to exceptions or exemptions that would be consistent with investor protection and efficient markets (*e.g.*, blanket customer consent to principal trades would be recognized).

- *Cross-Border Mutual Funds Subject to Mutual Recognition.*
  A mutual/reciprocal recognition program should be developed to allow U.S. mutual funds to be offered abroad and foreign funds to be offered in the U.S. with notice filings in lieu of fund registration. The program would require: (i) funds to opt into certain essential local requirements (*e.g.*, Section 17 of the 1940 Act would be a required opt-in provision for foreign mutual funds); (ii) base level accounting standards and disclosure standards (i.e., provisions ensuring that potential U.S. investors receive full and fair disclosure at least commensurate with current U.S. disclosure standards, including the new summary prospectus rules); (iii) revision of tax, pension, securities and other laws and regulations, as appropriate, to ensure even-handed treatment of U.S. and foreign funds and (iv) cooperative agreements between U.S. and foreign regulators relating to exercise of enforcement powers and oversight authority.

- *Insurance Regulation.*
  Consistent with the over-arching themes of consolidated and coordinated regulation, including cross-border cooperation among regulators, consideration should be given to allowing U.S. regulators to have information and, possibly, some amount of regulatory oversight for foreign reinsurers, including regulation of non-U.S. unauthorized reinsurers (encompassing the concept of granting U.S. insurers credit for reinsurance based on a single U.S. jurisdiction for such reinsurers). In addition, consideration should be given to proposals for insurance company optional federal charters including potential impact on state-based consumer protections, optional vs. mandatory federal charters, coordination of insurance company insolvencies, and coordination of holding company regulation among federal financial services regulators and international insurance regulators. Furthermore, the new Administration should consider commissioning a study of whether more coordinated or unified regulation of insurance in combination with other financial services products is warranted.

- *Office of Insurance Information.*
  The Obama Administration should consider establishing an Office of Insurance Information to (i) gather information on current state insurance regulation including coordination of interstate regulatory initiatives (NARAB, single state authorization for reinsurance credit, Surplus Lines licensing and premium tax); (ii) receive information regarding insurance companies and products affecting the

broader financial markets (e.g., financial guaranty insurance); (iii) study coordination of state regulation of insurance affecting global insurance and reinsurance transactions, international accounting initiatives and global trade issues; and (iv) study the need to provide coordinated examination authority over insurance companies that operate as part of a financial services conglomerate as well as the appropriateness of regulating insurance at the federal level in conjunction with regulation of other financial services providers.

- *Financial Reporting Regulation.*
  Unlike many other areas of financial regulation, there have been extensive changes in the rules and framework of financial reporting over the past several years, and there are many recent studies and developments that call for further refinement of those regulations, in addition to a movement toward global standards. In that vein, we recommend that the new Administration approach with caution making further changes in this framework, at least until the changes in this framework have been consolidated and the move toward global standards has been assessed, as noted below. We commend to the Administration the consideration of the key recommendations developed by the Treasury's Advisory Committee on the Auditing Profession and the SEC's Committee on Improvements to Financial Reporting.

- *International Financial Reporting Standards.*
  There is a growing movement toward global standards – the International Financial Reporting Standards ("IFRS"). The SEC has proposed to allow some U.S. issuers to adopt IFRS. Adopting this proposal, in a form that encourages issuer participation, would be a very important step forward. We note that the independence of the IFRS standard-setters is crucial to the development of global standards. The federal government (not limited to the SEC) should exert pressure on European regulators to pursue this objective. In allowing U.S. issuers to adopt IFRS standards, the SEC should continue to be mindful of possible enhancements drawn from existing U.S. standards that have provided important investor protections.

- *Regulating Consumer and Mortgage Debt and Assisting Debtors.*
  Amidst the concern over assisting and regulating the financial services industries, careful attention must be paid to consumer mortgage debt and other consumer debt that are major drivers of the current market instability and economic crisis. The Obama Administration should consider establishing some regulatory mechanism with monitoring capabilities which will focus on the consumer debt problem and which can grasp the entirety of the problem. It should be designed to (i) ensure compliance with appropriate lending standards and (ii) develop programs providing different types of relief and education for borrowers who are experiencing difficulties in discharging their mortgage debt or credit card obligations, taking into account the interests of holders of the mortgage or other collateralized debt obligations, such as pension funds that hold interests in the debt through securitizations.

- *Regulation of Predatory Lending.*
  Consistent with increasing regulation in the consumer debt area, consideration should be given to expanding federal regulation of entities engaged in predatory lending and mortgage fraud practices, including allowing for appropriate enforcement powers. For example, federal prosecutors have difficulty prosecuting predatory mortgage lending practices that do not fall under the Bank Fraud Statute's definition of "financial institution," pursuant to 18 U.S.C. §1344. Expanding the definition to include non-FDIC-insured institutions would provide more flexibility to regulators and prosecutors as they deal with the changing landscape of the financial markets. We suggest a review of the scope of regulation over these entities generally, as well as a review of other criminal statutes that may have implications for banking and mortgage lending practices in order to determine whether relatively modest legislative changes can be made to update those statutes to deal with the changing financial landscape.

- *Coordinated Focus on Money Market Mutual Funds and Recognition of the Significant Economic Impact these Funds have on Financial Markets.*
  A task force should be commissioned to evaluate regulation of money market mutual funds, taking into account the complex but important role played by the products in our markets, including providing short-term financing to the capital markets while being looked to as a safe-haven for savings. The task force would consider and, if appropriate, recommend changes to the existing regulatory structure, including consideration of the need for governmental insurance.

- *Securitization Markets in General.*
  The Term Asset-Backed Securities Loan Facility ("TALF") program is a good first step toward reviving the asset-backed and mortgage-backed securitization markets. However, it is fairly limited in scope and has a number of shortcomings; in particular, (i) it does not alleviate a big obstacle to new lending--namely, that potential lenders' existing warehouse facilities and balance sheets are full of previously originated assets that such lenders have not been able to securitize, (ii) the one-year term of a TALF loan may limit its effectiveness in stimulating lending funded by ABS issuance, because most AAA-rated tranches of consumer ABS have a term greater than one year; and (iii) it does not provide liquidity for the subordinate tranches of securitizations it proposes to stimulate. We encourage the Obama Administration to address these issues and consider other ways, consistent with the appropriate level of scrutiny for financial soundness, to revive the securitization sector so as to stimulate lending.

- *President's Working Group (PWG) on Financial Markets.*
  We support the PWG recommendations for credit default swaps as a means to reduce counterparty risk by (i) creating clearinghouses that will facilitate settlement and hold collateral and (ii) increasing transparency to make markets more efficient.

Conclusion

The Association of the Bar and its various committees would be happy to discuss its recommendations and work with members of the transition team, the Obama Administration and Congress in the undertaking of regulatory reform, generally and on specific issues. We thank you for the opportunity to present our views and look forward to this Administration's taking advantage of the opportunity it has been afforded to create a modernized, effective and responsive financial regulatory framework.

NEW YORK
CITY BAR

COMMITTEE ON INVESTMENT
MANAGEMENT REGULATION

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Mr. Andrew Donohue, Director
Division of Investment Management
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

December 20, 2007

Re: Recommendations with Regard to Reducing Unnecessary Burdens on Independent Directors

Dear Mr. Donohue,

The Committee on Investment Management Regulation of the New York City Bar (the "Committee") appreciates your recent invitation to comment on actions the Securities and Exchange Commission ("SEC") or the staff of the Division of Investment Management (the "Staff") might consider to alleviate unnecessary burdens on independent directors of investment companies registered under the Investment Company Act of 1940 (the "Act"). The Committee is composed of lawyers with diverse perspectives on investment management issues, including members of law firms, and counsel to financial services firms, investment company complexes and investment advisers. A list of our current members is attached as Annex A.

The last several years have witnessed many historic regulatory and enforcement developments in the fund area, and the SEC has emphasized in a number of rulemakings the important role played by independent directors of funds. In 2002 and 2004 the SEC adopted rule

amendments that were intended to improve fund governance by requiring funds that rely on certain exemptive rules to comply with various requirements, including measures intended to empower independent directors such as the requirements that any counsel to the independent directors of a fund must be an "independent legal counsel" and that independent directors must meet at least once quarterly in a separate session at which no interested persons of the fund are present.[1] The SEC's adoption of Rule 38a-1[2] under the Act in 2003 was intended, in part, to "strengthen the hand of fund boards".[3] Rule 38a-1 assures independent directors access to a source of compliance information that is answerable to them by requiring the designation by the board (including a majority of the independent directors) of a chief compliance officer ("CCO") whose compensation must be approved by the board (including a majority of the independent directors), and who cannot be removed without the action of such persons. Rule 38a-1 requires the CCO to be responsible for implementing the fund's compliance program, and that the CCO must report at least annually to the board and meet at least annually with the independent directors.

These initiatives were part of a very significant number of rulemakings by the SEC in recent years affecting fund boards, many of them in response to the Sarbanes-Oxley Act of 2002 as well as market timing, late trading, directed brokerage and other issues affecting the fund industry. A large number of the new and revised regulations that resulted from these initiatives have involved additional duties for fund directors, particularly independent directors. In addition, SEC commissioners and members of the Staff have, in numerous speeches, repeatedly emphasized the importance and duties of independent fund directors. Encouraged by the SEC, organizations such as the Mutual Fund Directors Forum and the Independent Directors Council have issued reports and recommendations and suggested numerous best practices for the consideration of independent directors.

In response to the problems in the fund industry that surfaced in 2003 and the various developments noted above, fund directors across the country have not only undertaken the new

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[1] Role of Independent Directors of Investment Companies; Investment Company Act Release No. 24816, January 2, 2001; Investment Company Governance, Investment Company Act Release No. 26323, January 15, 2004.

[2] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. IC-25925, February 5, 2003; Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. IC-26299, December 17, 2003.

[3] Id.

duties resulting from the SEC's various rulemakings, but also have worked with fund advisers and administrators to improve fund governance (including the quality of meeting materials) and disclosures. It should be noted that these actions were taken on top of a robust slate of pre-existing duties. As has been widely reported, fund board meeting agendas and materials have expanded significantly in recent years, and board and board committee meetings have generally become much longer and more frequent.[4]

The Committee is aware that many fund directors believe that too much of their time at board meetings is spent on routine compliance work or making required findings that can only be made, as a practical matter, in reliance on representations by an expert third party such as the fund's adviser or administrator. The Committee believes that it is inappropriate to require directors to devote significant attention to these types of matters, and that this is not in the best interests of funds or their shareholders. We suggest that director effectiveness could be increased, and protection of shareholders enhanced, by permitting compliance monitoring and expert determination responsibilities to be undertaken by others (in the case of compliance monitoring, the CCO (a position that did not exist when these burdens were devised), and in the case of expert determinations, the adviser or some other person with the appropriate expert capability), thereby permitting directors to focus more of their attention on matters that they believe important in discharging their duties to the funds.

The Committee commends the Staff's interest in assisting independent directors perform their unique role by determining whether certain of their duties, acquired over time from numerous and, to some extent, uncoordinated sources, might be removed or made less burdensome so as to permit them to focus on the many important matters that call for their time and attention.

Outlined below are four[5] areas where the Committee suggests changes that would reduce unnecessary burdens on independent directors, thereby improving fund governance and

[4] See, e.g., "The board weights ever more heavily on members' backs" at page 21 of the Financial Times Weekly Review of the Fund Management Industry on December 3, 2007.

[5] The Committee, recognizing Rule 12b-1 is the subject of a comprehensive review by the Staff and the SEC in light of the extensive developments since the Rule's adoption, does not address possible amendments to this rule herein, but suggests that consideration be given to modifying the requirement of Rule 12b-1(b)(3)(ii) that fund directors

enhancing investor protections. The Committee would welcome the opportunity to work with the Staff on the implementation of any or all of these suggestions.

Elimination of Quarterly Review of Transactions Effected Pursuant to Certain Exemptive Rules

Independent directors have long had compliance oversight responsibilities with respect to transactions effected pursuant to certain exemptive rules under the Act; specifically, to determine no less frequently than quarterly that each transaction effected in reliance on Rules 10f-3 (purchases of securities in an underwriting in which an affiliated person is a participant), 17a-7 (trades between funds and certain affiliated persons managed by a common adviser), or 17e-1 (transactions using affiliated brokers) was effected in compliance with procedures adopted by the fund's board (including a majority of the independent directors) that are reasonably designed to comply with the requirements of the relevant rule. Boards normally fulfill this responsibility by receiving each quarter reports of each transaction effected in reliance of one of these rules in the prior quarter. In some fund groups there may be very few such transactions in a quarter, while in others there may be thousands.

The reports presented to directors to enable them to make the required findings under these rules necessarily include information designed to show compliance with each exemptive rule requirement, and determining compliance is a relatively mechanical exercise. Compliance personnel will have investigated transactions that appear to raise compliance issues in advance of the board meeting in order to be able to discuss such transactions with the directors and either explain why they are deemed compliant or, in the event of a violation of the procedures, the remedial action that has been taken or is proposed to be taken. The directors are heavily reliant on the adviser, the administrator or the CCO to capture the proper data, identify and investigate and report on potentially non-compliant transactions. Nonetheless, the rules require that the directors (including a majority of the independent directors) review each transaction and determine that it was effected in compliance with the fund's procedures. The Committee

receive and review, at least quarterly, written reports of the amounts expended under a plan and the purposes for which such expenditures were made. In many cases this requirement leads to routine and potentially lengthy reports that merely state that amounts computed at approved rates have been paid for the purposes previously authorized, and many directors question the value of such reports.

suggests that requiring independent directors to function as compliance analysts in this way is not an appropriate use of their time, and is not in the best interests of investors.

The Committee notes that these exemptive rules were adopted long before Rule 38a-1 provided fund directors with a CCO,[6] and that the procedures required by the rules (which normally are adopted at the time a fund is organized) form a part of the comprehensive compliance programs approved by the directors and administered by the fund CCO as required by Rule 38a-1. Directors and CCOs have invested substantial time and attention in implementing compliance programs since the adoption of Rule 38a-1. Consistent with Rule 38a-1, CCOs receive oversight and derivative authority from the independent directors, while independent directors rely on the CCO for reports on the implementation and updating of the compliance program.

Although Rule 38a-1(a)(4)(iii) requires that the CCO report to a fund's board and meet with the independent directors at least annually, the Committee believes that in practice most CCOs report to the board and the independent directors at least quarterly. The Committee believes that it would be reasonable and appropriate, and in the best interests of investors, for the SEC to adopt rule amendments to permit (but not require) directors to satisfy their quarterly review obligations under Rules 10f-3, 17a-7 and 17e-1 by receiving quarterly reports from the CCO on compliance with the funds' procedures relating to these rules in lieu of receiving reports on each individual transaction effected pursuant to the procedures and we recommend that the SEC amend these rules to permit this. The Committee further recommends that the SEC not specify the form of such reports so that directors can have the flexibility to design reporting that is appropriate for them, which may involve reporting on an exception basis. The Committee recognizes that not all Boards (or CCOs) may wish to proceed in this manner, and therefore, the Committee recommends that the SEC give directors the option to receive a quarterly report from the CCO in lieu of transaction reporting, as they see fit.

The Committee notes the cautionary observations concerning this type of approach raised in your November 6, 2007 Keynote Address at the Independent Directors Conference. You stated that there may be a danger of overburdening the recently created office

[6] Rules 10f-3, 17a-7 and 17e-1 were originally adopted in 1958, 1966, and 1979, respectively.

of CCO with responsibilities and questioned whether the CCO is the right person to shoulder a particular responsibility. The Committee notes that Rule 38a-1 already makes it the CCO's responsibility to administer all of a fund's compliance policies and procedures, including those adopted pursuant to exemptive rules. Administration necessarily involves being satisfied that the procedures are being complied with. With respect to whether or not the CCO is the right person to prepare and deliver the proposed compliance reports to fund boards, given the CCO's existing responsibility to administer the procedures in question, the Committee believes that the CCO would indeed be the right person. Moreover, the Committee believes that both concerns raised in your speech are addressed by the proposal that the delegation be optional. Consistent with their duties to a fund, directors would, in the ordinary course, consider whether a proposed delegation is in the fund's best interests and thus would necessarily include consideration of the appropriateness of the CCO as delegee.

Elimination of Quarterly Reviews Required by Existing Exemptive Orders

Based on its review of numerous exemptive orders that have been issued under the Act, the Committee observes that many of them have conditions that, like the three exemptive rules discussed above, require independent directors to adopt policies and procedures and to monitor the implementation of such policies and procedures. These types of conditions raise the same issues as the three exemptive orders – they require the independent directors to act as compliance analysts, which is not consistent with their supervisory authority over funds or in the best interests of investors. Rule 38a-1 requires funds operating in reliance on exemptive orders to have compliance policies and procedures reasonably designed to ensure compliance with the conditions in the exemptive orders relied upon, and makes the fund's CCO responsible for administering such policies and procedures.

The Committee recommends that the Staff consider supporting a blanket order or interpretation from the SEC that effectively amends the terms of existing exemptive orders such that directors may satisfy their monitoring responsibilities thereunder by receiving and reviewing quarterly reports from the CCO about compliance with policies and procedures adopted in connection with exemptive orders of this type. The Committee also recommends that the SEC consider incorporating this approach into exemptive rules codifying categories of frequently granted exemptive orders (including, *e.g.*, the pending rule proposals on changing subadvisers

without shareholder approval and on exchange traded funds). This would be consistent with the approach recommended in the preceding section, and is also generally consistent with the proposed conditions for 19(b) orders released by the Staff late last year and which will presumably be reflected in the rule proposal for managed distribution plans that are contemplated in those conditions.

Determinations that Should be Made by the Adviser or Some Other Expert Subject to General Board Oversight Rather than by the Board

There are a number of rules that require board determinations that, in the Committee's view, unreasonably burden directors with responsibility for determinations that many of them may not be qualified to make except in reliance on others and that, in practice, must generally be made by the fund's adviser or some other expert and ratified by the board in reliance on such person's representations. The Committee has identified many examples of required determinations of this type. A few examples include: Rule 2a-7(a)(10)(ii) and (12)(ii), which require directors to determine that an "Unrated Security" is of comparable quality to a security meeting the requirement for a "Rated Security"; 17d-1(d)(7), which requires independent directors to find that each fund's share of a joint insurance policy premium is fair and reasonable "based upon its proportionate share of the sum of the premiums that would have been paid if such insurance coverage were purchased separately by the insured parties"; and Rule 23c-3(b)(10)(iii), which requires directors of closed-end interval funds to review portfolio composition in order to assure adequate liquidity to satisfy repurchase obligations.

The Committee suggests that the SEC revise all of such rules based on the following guiding principles. First, determinations that draw only upon professional investment expertise peculiarly within the possession of the adviser (*e.g.*, determining the comparable quality of Unrated Securities in Rule 2a-7) or that, if assigned to the directors, would require a degree and frequency of involvement that extends beyond the board's proper oversight role (*e.g.*, reviewing portfolio composition to assure adequate liquidity) should be left to the adviser, subject to the general oversight of the board of directors and the implementation of policies and procedures approved by the fund's board as part of the Rule 38a-1 compliance program. In addition, where the board's required involvement appears to be only a "checking" function (as in the comparable quality determinations under Rule 2a-7) assigned to the board as the only party available to appoint so that fund advisers would not be performing advisory duties solely on the honor

system, the Committee recommends that the relevant rules should be amended to give independent directors the flexibility to delegate such checking to the CCO (who did not exist when these rules were adopted).

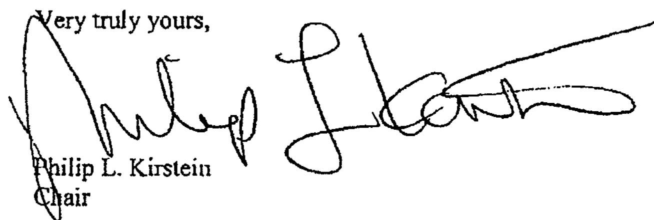
Fair Value Responsibilities under the Act

The Board's responsibility to determine, in good faith, the fair value of portfolio securities for which market quotations are not readily available, is unreasonably burdensome in the case of many funds. The Committee suggests that the SEC support an amendment to the Act to remove this requirement in recognition of the enormous changes to the fund industry and the financial markets since the requirement was enacted and that Board involvement in valuing specific portfolio assets is no longer necessary or appropriate. For example, accounting standards such as SFAS No. 157 (which "defines fair value, establishes a framework for measuring fair value [for purposes of GAAP], and expands disclosures about fair value measurements") provides a rigorous framework for determining fair values and must be used for a fund's financial statements from and after its implementation date. The Committee suggests that current accounting standards, as they may be amended or interpreted from time to time, and board oversight (including board approval of policies and procedures for valuing illiquid securities) together with the existence of a CCO, are sufficient to deal with the conflicts that advisers are subject to in connection with pricing securities for which market quotations do not exist. In the Committee's view, there is no reason to have fund boards directly involved in fair valuing securities and the current widespread practice of asking them to ratify specific fair values (thousands of such values in some cases), often months after the fact, is not satisfactory for many reasons and imposes an unreasonable burden on directors.

* * *

As noted above the Committee would be pleased to work with the Staff on the implementation of any or all of the above suggestions, and would also welcome the opportunity to discuss other opportunities to reduce unnecessary burdens on fund directors that the Staff has identified. Please do not hesitate to contact the undersigned by telephone at (212) 969-2108 or by e-mail at phil.kirstein@alliancebernstein.com.

Very truly yours,



Philip L. Kirstein
Chair

Attachment

Attachment not included

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October 1, 2008

Ms. Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-22-08
Proposed Guidance; Request for Comment – 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 Committee on Investment Management Regulation of the New York City Bar (the "Committee") is composed of lawyers with diverse perspectives on investment management issues, including members of law firms, and counsel to financial services firms, investment company complexes and investment advisers. A list of our current members is attached as Annex A.

This letter responds to the request of the Securities and Exchange Commission (the "Commission") in the Commission's Release 34-58264 (July 30, 2008) (the "Release") for

comments on its proposed guidance (the "Proposed Guidance") to boards of directors of investment companies registered under the Investment Company Act of 1940 (the "Act"). The Committee understands that the Proposed Guidance is intended to propose a flexible framework for fund directors to work within when evaluating a fund adviser's trading practices.[1] The Release states that the Proposed Guidance would not impose any new or additional requirements on fund directors or advisers.[2]

The Committee supports the Commission's objective to provide guidance to fund directors regarding performing their oversight role in the most effective and efficient manner possible.[3] The Committee acknowledges that the Proposed Guidance contains a great deal of background information and lists of questions that some fund directors may find helpful in exercising their oversight responsibilities. The Committee also acknowledges that the Release responds to the requests of many fund directors who have requested guidance from the Commission regarding how they should fulfill their oversight responsibilities with respect to an adviser's use of fund brokerage commissions.

As will be elaborated further herein, the Committee believes that the Proposed Guidance, if adopted in its current form, could in fact be interpreted as imposing responsibilities and burdens on fund directors in addition to those that currently exist. There are several aspects of the Proposed Guidance which the Committee suggests the Commission change to further its

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1 *See* Speech by SEC Chairman: Statement at Open Meeting on Guidance to Fund Boards Regarding Investment Adviser Trading of Fund Portfolio Securities and Use of Soft Dollars (July 30, 2008) ("SEC Chairman Speech") *at* http://www.sec.gov/news/speech/2008/spch073008cc_iaportfolio.htm.

2 *See* Sections I and III of the Release.

3 *See* SEC Chairman Speech , *supra* note 1 ("[The Commission's] goal is to help directors focus their review efforts and evaluate an adviser's trading activities in the most efficient and effective way possible").

goal and to ensure that the Proposed Guidance does not in fact impose any additional requirements on fund directors. As discussed below, these relate to the summary of state and common law fiduciary principles, the "checklist" nature of the Proposed Guidance and the volume of fund by fund information contemplated thereby, the requirement that fund boards make specific "determinations" as to the adviser's compliance with applicable law, the references to "inappropriate" cross subsidization (which, in the Committee's view, could be read as suggesting that a fund board should almost never allow an adviser to cause the fund's brokerage to be used to purchase research), and the statement regarding consideration of soft dollar benefits to the adviser in connection with the fund boards' review of advisory contracts under Section 15(c) of the Act. The Committee strongly recommends that the Commission issue the "final" guidance in the near term in order to address these concerns, since so long as the Proposed Guidance is outstanding it may have unintended effects.

In addition, the Committee acknowledges that the Proposed Guidance is not a proposed rule, and thus may not technically trigger the requirement for impact analyses (such as a cost-benefit analysis or Paperwork Reduction Act analysis). However, as discussed herein, compliance with the new obligations on fund directors, referred to above, could involve very significant costs for funds and their advisers. While the Committee recognizes that conducting such analyses on the Proposed Guidance may delay the issuance of final guidance, it believes that such efforts would demonstrate the significant costs of the Proposed Guidance in its current form and urges that the they be conducted. The Committee would welcome the opportunity to work with the Commission on the implementation of any or all of its suggestions.

State and Common Law Regarding the Fiduciary Duties of Fund Directors

In Section II of the Release, the Commission emphasizes the importance of fund directors understanding "the nature and source of their legal obligations to the fund and the fund's shareholders." Section II of the Release states that "[b]ecause funds are generally formed as corporations, business trusts, or partnerships under state law, fund directors and trustees . . . are subject to a 'duty of care' and a 'duty of loyalty' under state and common law fiduciary principles." It then goes on to provide a summary of state and common law fiduciary principles applicable to fund directors, citing various sources, such as the Maryland General Corporation Law, the Model Business Corporation Act, and Delaware case law.

Although the Committee appreciates the importance of establishing context for the Proposed Guidance, the Committee believes that the duties of directors under various state laws may be subject to a great deal of variation. An analysis of a specific state's applicable law in light of a fund director's particular circumstances may yield different results from what is summarized in the Release. Accordingly, the Committee believes that the final version of the Proposed Guidance should clarify that its summary of state and common law duties of directors reflects the Commission's view of certain state law principles only, does not constitute legal advice concerning directors' duties under the laws of any particular state, and should not be accorded deference by courts as it does not relate to the Commission's interpretation of any Federal securities law. In this regard, the Committee recommends that the Commission's final guidance direct fund boards to seek appropriate legal advice on the duties applicable to them under the state law relevant to their particular circumstances.

Eliminate the "Checklist" Nature of the Proposed Guidance

The Release generally states that the Proposed Guidance sets forth non-exclusive lists of information a fund board should request from the fund adviser to enable it to determine that the adviser is fulfilling its fiduciary obligations to the fund and using the fund's assets, including brokerage commissions, in the best interests of the fund.[4] As discussed in the next section, the Committee does not believe that fund boards have a responsibility to make such a "determination." In addition, while some of the information in the lists appears to be of a "general background" nature, and designed to ensure that boards are knowledgeable about the adviser's best execution policies and the quality of executions achieved (*e.g.*, the "related matters" bullet points in Section III.A), others appear to contemplate detailed fund by fund information that may be extremely costly to prepare and of limited or no utility to fund directors (*e.g.*, the fund by fund information discussed under "References to "Inappropriate" Cross-subsidization" below).

While the Committee recognizes that the Commission states in its Proposed Guidance that "different factors may be appropriate for different funds, depending on a fund's investment objective, trading practices, and personnel,"[5] the Committee believes that the lists of types of information fund boards should request in the Proposed Guidance, in their current form, without further context (such as how the lists would apply differently with respect to certain funds or types of organizations), may have the negative, unintended consequence of creating increased litigation exposure for directors who choose to deviate from the listed questions in the Proposed Guidance. The Committee believes that such increased litigation exposure for

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4 *See* Sections I and III of the Release.

5 Section III.A of the Release.

directors would likely result in the establishment of a "one-size fits all" review approach, since directors, investment advisers and counsel may reasonably infer that they may have to justify any deviation from the listed questions to plaintiffs' lawyers and Commission examiners. The Committee also believes that the checklist approach of the Proposed Guidance may lead to inefficient and ineffective director reviews more concerned with form than substance. *See also* "Unnecessary Burdens on Fund Directors" below.

The Committee recommends that the Commission eliminate the lists of information in the final guidance for the reasons described above and to avoid any potential for ambiguity created from the Proposed Guidance, which is intended to impose no new requirements. To the extent the final guidance includes lists, the Committee urges the Commission to make it very clear that it is not suggesting that such lists, or any particular factor, question, or piece of information set forth therein, are appropriate for all fund groups, that fund boards should consider the totality of circumstances in determining what information they wish to review in exercising their oversight responsibilities in respect of portfolio trading practices, and that there will be no burden on fund boards to prove (*e.g.*, to the Office of Compliance Inspections and Examinations) why they are not asking for something on any such list.

Fund Boards Should not be Responsible for Making Specific "Determinations" about the Adviser's Compliance with the Adviser's Obligations under Applicable Law

Although the Proposed Guidance states that it would not impose any new or additional requirements, it contains a number of statements regarding specific "determinations" fund boards should make (or that it is implied that boards should make), which the Committee believes are new, very specific and burdensome, and inconsistent with the general oversight responsibilities of fund boards. The Committee agrees that fund directors have "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" (as stated in Section I of the Release) and that fund boards are required by Rule 38a-1 to approve policies and procedures of the fund adviser that are reasonably designed to prevent the adviser's violation of the Federal securities laws (as stated in Section II.A). The Committee does not agree, however, that fund directors are required to make specific determinations about the adviser's compliance with its obligations or to assume responsibility for the administration of the adviser's compliance policies and procedures relating to portfolio transaction executions.

Rule 38a-1 specifically provides that the chief compliance officer (not the board) is responsible for administering the fund's compliance policies and procedures (*see* Rule 38a-1(a)(4)). The Committee is concerned that the Proposed Guidance's numerous references to "determinations," and suggestions that fund boards must request and receive vast amounts of detailed information (on a fund by fund basis) in order to fulfill their oversight duties, risks causing fund boards to far overstep the separation between general oversight and involvement in day to day management or routine compliance monitoring. In the adopting release for Rule 38a-1 the Commission was very clear that when considering a fund's compliance program, fund boards may rely on summaries of the policies and procedures prepared by the fund's chief compliance officer or some other responsible person. However, the Proposed Guidance could be read as establishing a much more burdensome requirement for approval of policies and procedures relating to trading practices, and a requirement for detailed ongoing monitoring of their implementation by fund boards.

The Committee has identified a number of places in the Release that appear to require a fund board to "determine" that the adviser is trading "in the best interests of the fund." A few examples include:

- Section I ("[I]t is imperative that the fund's directors . . . determine that payment of transaction costs is in the best interests of the fund and the fund's shareholders" and "[w]ithout 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");
- the introduction to Section III (a fund board "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");
- Section III.A ("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");
- Section III.B ("When evaluating an adviser's use of fund brokerage in light of these conflicts, a fund board may determine that such use is in the best interests of the fund"); and
- Section III.D ("if a fund board determines that the adviser's use of brokerage commissions is not in the best interests of the fund, the board should prohibit or limit the use of fund brokerage," "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," and "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").

The Committee believes that fund boards should be satisfied that the adviser has in place policies and procedures reasonably designed to ensure compliance with its best execution obligations and other applicable laws, including to ensure that the adviser's soft dollar arrangements fall within Section 28(e) of the Securities Exchange Act of 1934, and that boards should request such additional information as they deem necessary to be satisfied that fund brokerage is being appropriately used. Fund boards should not be responsible for making

periodic specific direct or indirect "determinations" about the adviser's compliance with the adviser's obligations under applicable law. Making such determinations would require a degree and frequency of involvement in the adviser's business (extending far beyond registered investment companies) that exceeds the board's oversight role as reasonably construed. Thus, the final guidance should reemphasize that the board's role is one of oversight. The Committee suggests that the final guidance emphasize that fund boards may exercise oversight in a number of ways, and that the guidance is not designed to require a fund board to make specific formal determinations or findings concerning the fund adviser's trading practices or soft dollar arrangements.

References to "Inappropriate" Cross Subsidization

The Proposed Guidance also suggests that soft dollar information be provided, and directors' reviews and "determinations" be made, on a fund by fund basis. Section II.E of the Release provides that "at a minimum" fund directors should require advisers to provide information "regarding 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 should . . . consider whether the adviser properly accounts for use of fund brokerage commissions to purchase research that primarily or solely benefits another client of the adviser."

The Committee agrees that it may be inappropriate for an adviser to use the brokerage commission of one group of its accounts to pay for research that exclusively benefits a different group of accounts. However, the Committee believes that the "inappropriate cross-subsidization" language in the Proposed Guidance[6] is troublesome and may have unintended

[6] *See e.g.*, Section III.D of the Release (providing that the adviser should explain to the board whether the

consequences. The Committee identified three major problems with the Commission's proposed guidance in this area. First, it presumes that investment advisers structure their soft dollar budgets on a client by client basis; however, as discussed below, structuring soft dollar budgets in such a manner is generally impracticable and inconsistent with the realities of an adviser's business. Second, it contemplates an ability to quantify and allocate the benefits of research acquired with soft dollars that is not realistic given the "soft" nature of the value of different types of research to different clients (*e.g.*, how can the benefit of an insight on a particular stock be both quantified and allocated among numerous clients that may be, to a greater or lesser extent, able to invest in that stock?). Most importantly, the language in the Proposed Guidance could be read to suggest that cross subsidization is "inappropriate" in many more situations than the example quoted at the beginning of this paragraph, and potentially in almost every situation. The Committee urges that the final guidance be recast in light of these concerns.

The Proposed Guidance Presumes that Soft Dollar Budgets Can be Prepared on a Client by Client Basis

There is a very large amount of variation in the size and complexity of the investment advisers that advise investment companies. Some advisers may advise one fund and a few managed accounts, while others may advise hundreds of funds and the accounts of tens of thousands of other clients including "wrap" accounts, plans subject to ERISA, collective investment trusts, foundations and other accounts. For advisers with multiple accounts, it would be both impracticable and inconsistent with the realities their businesses, which involve trading departments that "work" trades on behalf of all or most clients, to prepare soft dollar budgets on a client by client basis. The Committee believes that this aspect of the Proposed Guidance is

brokerage and research services purchased with final brokerage commissions are "inappropriately benefiting another of the adviser's clients at the fund's expense").

based on an unworkable premise that soft dollar budgets can and should be prepared on an client by client basis.

The Proposed Guidance Presumes that the Cost of Research may be Valued with Precision and its Value to Different Accounts may also be Precisely Quantified and Allocated

While it may be possible to quantify the value of some (but by no means all) Section 28(e) research by reference to the hard dollar cost of the same research, the Committee notes that Section 28(e) research, by definition, benefits multiple (sometimes thousands) of the adviser's clients in ways that are not possible to quantify on a client by client basis. In addition, there are very substantial categories of research (in particular proprietary research) that are not generally available for purchase with hard dollars. The Proposed Guidance, however, speaks of the need to avoid "inappropriate" cross subsidization in a way that could be read to require a determination of whether "appropriate cross subsidization" exists, and suggests that both the costs and benefits of research may be quantified on an account by account basis.[7] The Committee strongly recommends that the final guidance explicitly recognize that while it may be possible in many cases to determine whether or not a particular kind of research may benefit particular categories of clients, it is not normally possible to quantify the value of the research to individual clients, and that it is the nature of most research that it benefits all clients that may invest in similar types of securities..

Uncertainty about Meaning of "Inappropriate" Cross Subsidization

The Proposed Guidance also suggests that fund boards should request that the fund adviser inform them about whether the adviser has "other clients paying lower commissions

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7 *See* Section III.D of the Release.

that do not include a soft dollar component," and "[i]f 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?"[8] The Committee understands that many advisers have clients that direct their brokerage transactions to a specified broker (*e.g.*, any wrap account, or an institutional account that is obtaining a benefit in return for having its brokerage transactions effected through a specified dealer or dealers). Such clients may benefit from research purchased with soft dollars paid by other clients.

The Committee is concerned that the Proposed Guidance could be read to suggest that the existence of even one such "free rider" among an adviser's clients results in an insuperable "cross subsidization" problem that must result, in the Commission's view, in a fund board directing that the fund's brokerage not be used to pay for research in spite of the clear Congressional policy of Section 28(e).

If cross subsidization is truly something that fund directors should object to, there is no need for the existence of free riders to result in a problem for fund directors. Taken to an extreme, should directors be concerned that the brokerage generated by a large account investing in small cap growth stocks may be paying for significant amounts of research that "disproportionately" benefits a very small account invested in the same stocks, even if exactly the same percentage of the brokerage of each account is applied to payment for such research? The members of the Committee are not aware of any institutional client of an investment adviser that receives the type of cross subsidization analysis that seems to be contemplated in the Proposed Guidance. Accordingly, the Committee requests an acknowledgement by the

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[8] *Id.*

Commission in the final guidance that cross subsidization is inherent whenever research may benefit multiple accounts.

Section 15(c) Information

In Section III.E of the Release the Commission states that a fund board's review of the adviser's compensation under Section 15(c) of the Act "should incorporate consideration of soft dollar benefits that the adviser receives from fund brokerage", citing *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F. 2d 923 (2d Cir. 1982). The Committee notes first that Gartenberg is not the law in all circuits (*see, e.g. Harris Assoc.* v. *Jones*, No. 07-1624 (7th Cir. May 19, 2008) and the cases cited by the court at page 8). In addition, the Gartenberg language quoted in footnote 86 of the Release makes it clear that soft dollar benefits are an example of "fall-out benefits" which, in the aggregate, "could be a factor of sufficient substance" to affect the directors' assessment of the fee (*see also Krinsk* v. *Fund Asset Management, Inc.*, 715 F. Supp. 472 (S.D.N.Y. 1988) which discusses the difficulty of quantifying the "fall-out benefits" attributable to a fund).

The Committee is concerned that the Proposed Guidance could be read to suggest to fund boards that they must attach an exaggerated importance to fund brokerage in the Section 15(c) process when it is only one among many factors that should be considered (and one that may be immaterial in many cases). The Committee requests that the final guidance make it clear that soft dollar benefits are one of many things that it may be appropriate for directors to take into account, depending on the circumstances, when considering the initial approval or continuance of an advisory contract. Also, the Committee recommends that any future guidance from the Commission regarding the Section 15(c) process not include a "checklist" of

information that fund boards should request, and advisers should provide, because of the issues with checklists noted above.

Unnecessary Burdens on Fund Directors

On December 20, 2007, in response to an invitation from the Director of the Division of Investment Management, the Committee submitted a comment letter (attached as Annex B hereto) recommending various actions the Commission or the Commission Staff might consider to reduce unnecessary burdens on fund directors, thereby increasing director effectiveness so that they can devote attention to matters important to their fund in light of their particular circumstances. In that letter the Committee noted that many fund directors believe that too much of their time at board meetings is spent on routine compliance work or making required findings that can only be made, as a practical matter, in reliance on representations by an expert third party such as the fund's adviser or administrator. The Committee further noted its belief that the ability of fund directors to exercise their general oversight responsibilities under state law is hindered to the extent they must devote significant attention to these types of matters, and that this is not in the best interests of the funds or their shareholders.

The Committee respectfully suggests that these concerns are very relevant to the aspects of the Proposed Guidance commented upon above, and that director effectiveness and protection of shareholders could be enhanced by reflecting the Committee's comments in the final guidance. The Committee believes that these changes would provide directors with the flexibility to focus more of their attention on matters they believe are important in discharging their duties to the fund without the concern that they may have to justify any deviation from the approach suggested by the Proposed Guidance to plaintiffs' lawyers and Commission examiners.

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As noted above the Committee would be pleased to work with the Commission on the implementation of any or all of the above suggestions, and would also welcome the opportunity to discuss other opportunities to reduce unnecessary burdens on fund directors that the Commission has identified. Please do not hesitate to contact the undersigned by telephone at (212) 969-2108 or by e-mail at phil.kirstein@alliancebernstein.com.

Very truly yours,

Philip L. Kirstein

Philip L. Kirstein
Chair

Attachments

cc: The Honorable Christopher Cox, Chairman
The Honorable Kathleen L. Casey
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes

Andrew J. Donohue, Director
Division of Investment Management

Attachments not included