ROPES & GRAY

2006 Mutual Funds and Investment Management Conference

March 19 - March 22, 2006

Summary Report

The following lawyers attended the conference and contributed to the preparation of this report:

Alyssa Albertelli
Bryan Chegwidden
Gregory C. Davis
Timothy W. Diggins
John W. Gerstmayr
Thomas R. Hiller
Susan A. Johnston
John M. Loder
Brian D. McCabe
Gregory D. Sheehan
David C. Sullivan
James E. Thomas

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Keynote Addresses

Speaker: Paul Schott Stevens, President, Investment Company Institute

Mr. Stevens began his remarks by briefly describing the Institute's activities over the past year, including assisting with implementation of the compliance and redemption fee rules, recommending to the Department of Labor prohibited transaction reform and guidance on default investments, advocating tax legislation which would extend favorable tax rates on capital gains and dividends and supporting the work of the Independent Directors Council.

Mr. Stevens then focused on two issues: how the mutual fund industry could better inform investors and how it can better equip investors to save for retirement. As to the first matter, Mr. Stevens noted the growing use of the Internet, stating that nearly 90% of mutual fund investors have access to the Internet, about two-thirds of those with Internet access go online at least once a day and nearly 60% of fund investors who go online use the Internet to obtain investment information. Mr. Stevens then identified the Internet as a means for dealing with the constant tension between providing too much information or simplifying things too much such that relevant information was no longer provided. He labeled the current rules as promoting "one size fits none" disclosure. He said the Internet would allow different users to access and analyze the level and types of data most useful to them. Mr. Stevens applauded the SEC's XBRL initiative, but said that in order to allow fund investors to reap the benefits of XBRL, a custom-designed taxonomy must be created. To that end, he announced that the ICI was launching an initiative to develop a broader XBRL taxonomy for mutual fund disclosure.

In terms of the second goal – encouraging investors to save for a secure retirement – Mr. Stevens noted that Congress was currently considering comprehensive pension reform legislation and identified three areas to consider:

- broadening the saving population by requiring automatic enrollment, permitting the employee to opt out of the pension plan;

- facilitating good investment decisions by designating default investment options consistent with the saving needs of employees and modernizing the rules as to who may provide investment advice to employees; and

- rejecting the notion of lowering savings incentives by making permanent the increased contribution limits initially passed in 2001.

* * * *

Speaker: Senator Jon Kyl, Chairman, Senate Republican Policy Committee

Senator Kyl discussed three topics: tax legislation, pension reform and the estate tax. With respect to tax legislation, Senator Kyl said he believed that Congress will be successful in approving legislation that would extend for another two years the current capital gain and dividend rates, noting that the rates provided a stimulus to the economy, were favored in opinion polls and conferred a benefit across the socio-economic spectrum.

With respect to pension reform, Senator Kyle was less optimistic about the chances of legislation passing, noting that the upcoming election may negatively impact the chances of reform legislation being passed.

Finally, with respect to making permanent the elimination of the estate tax, Senator Kyl said that he believed that a compromise in Congress was possible, whereby a $5 million exemption from the estate tax could be introduced, indexed for inflation.

* * * *

Speaker: Ann L. Combs, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor

<u>Overview</u>. Ms. Combs began her address by emphasizing the importance of retirement savings and stressing the increasingly important role played by the mutual fund industry in ensuring that American workers can retire with dignity and financial security. Ms. Combs explained that 54 million households, totaling 92 million individuals, currently invest in mutual funds. Over half of these individuals invest through workplace retirement plans.

Ms. Combs stated that while the SEC broadly focuses on enforcing securities laws, the U.S. Department of Labor (the "DOL") protects a particular category of investors – those individuals investing in employee benefit/retirement plans. The DOL ensures such protection by enforcing regulations governing such plans. Given the increasing prevalence of retirement plan investments in mutual funds, Ms. Combs explained, the DOL would like to work cooperatively with the mutual fund industry to increase access to investment advice and to enhance the protection of retirement savings.

<u>Legislative and Regulatory Developments</u>. Ms. Combs then addressed pension reform legislation currently pending in Congress. According to Ms. Combs, pension reform legislation has been passed by both houses of Congress and currently is in a House-Senate Conference Committee, which will resolve the differences between the House- and Senate-passed versions of the legislation.

The proposed legislation, among other things, attempts to remedy ERISA limitations affecting individuals' access to investment advice. Under the House-approved version of this legislation, Ms. Combs explained, individuals would have greater access to investment advice. The proposal would allow employers to provide their workers with access to professional investment advice as a benefit as long as advisers fully disclose any fees or potential conflicts. The proposed legislation also includes significant safeguards to ensure that workers receive advice solely in their best interests. Ms. Combs pointed out that the Senate version of this legislation is weaker in this regard, but does not go beyond the SunAmerica Advisory Opinion.

Addressing regulatory trends, Ms. Combs indicated that the DOL sees a need to modernize ERISA, given recent retirement and investment trends. The DOL wants to minimize transaction costs, yet at the same time protect plan investors. Currently, Ms. Combs explained, there is substantial interest in automatic enrollment in 401(k) plans. In such plans, employees are enrolled unless they affirmatively choose to opt out of the plan. Given this situation, the DOL, as part of its oversight role, is interested in how the employee contributions are invested.

Currently, in the absence of employee guidance, contributions are invested in money market funds.

Ms. Combs stated that the DOL does not currently regulate the particular amounts of fees charged to retirement fund investments. She stated that the only requirement is that the retirement plan cannot pay more than a reasonable amount of compensation for investment services, and the retirement plan must be familiar with the investment fee structure to ensure that the fees are justified.

Conclusion. Ms. Combs concluded by stressing that the recent trends in retirement investment have made the relationship between the DOL and the SEC increasingly significant. She added that the mutual fund industry can contribute to the success of regulatory policy changes by coordinating industry efforts with those of government regulators, including both the DOL and the SEC.

Communicating More Effectively with Shareholders: The Increasing Role of the Internet

Moderator: Randall W. Merk, President, Schwab Financial Products, Charles Schwab & Co.

Speakers: Michael J. Downer, Senior Vice President, Capital Research and Management Company
Bill Doyle, Vice President, Research, Forrester Research
Alexander C. Gavis, Vice President and Associate General Counsel, Fidelity Investments
William D. Lutz, Professor of English, Rutgers University

Mr. Merk indicated that the general purpose of the session was to consider ways to improve communications with shareholders through the use of technology. At Mr. Merk's request, Mr. Doyle provided several statistics to help frame the discussion. Mr. Doyle noted that:

- approximately 88% of mutual fund shareholders have Internet access;
- mutual fund shareholders as a group are more likely to have Internet access (and more likely to have broadband connections) than the U.S. population generally;
- whereas the percentage of mutual fund shareholders with Internet access continues to grow at a modest rate, the percentage of shareholders with broadband access was still growing rapidly;
- most mutual fund shareholders of all ages have Internet access, and age-based gaps in access are narrowing (i.e., most shareholders over age 65 now have Internet access); and
- most mutual fund shareholders use the Internet frequently, including for financially-related purposes.

The panel discussed a range of questions regarding the use of technology by fund firms:

Has the Internet replaced paper? Is this really an "either/or" question? Professor Lutz commented that age 55 appeared to be a dividing line as to whether a person uses the Internet to make decisions. Several panelists agreed that while mutual fund shareholders have high Internet utilization rates, the prospectuses and other documents available to them online were generally ineffective. Mr. Downer noted that while electronic media may not be a complete substitute for paper, technology could help fund firms to rethink how they use paper. By way of example, he discussed the possible use of "layering," whereby firms could develop shorter, more concise paper documents that could in turn refer readers to a website for additional detail. Mr. Gavis commented that the mutual fund industry faced both near term challenges – such as linking the ways fund companies communicate with shareholders (e.g., web, telephone, branches) – and long term challenges – such as making the Internet shareholders' preferred method of delivery.

The panelists also advanced several theories as to why shareholders have turned to intermediaries in increasing numbers in recent years. One panelist suggested it was due to the availability of too much information. Another panelist suggested it was inherent in the nature of a service economy.

<u>Can we assume that all mutual fund shareholders have Internet access?</u> The panelists agreed it would be premature and inappropriate to do so at this time. Mr. Doyle observed that an important percentage of mutual fund shareholders still lack Internet access, and that a significant percentage of these shareholders (particularly seniors, rural households and households with below median compensation) have indicated that they do not expect to have Internet access in the near future, if ever.

<u>What technological tools exist to help provide information to shareholders?</u> The panelists discussed the use of XBRL technology as one means to facilitate shareholder and advisor research. The panelists also discussed the need to make websites more user friendly. Mr. Doyle commented that we were still in the very early stages of learning what architecture was most useful for presenting information.

<u>How can fund firms balance the risk of liability with providing information in a more concise format?</u> Mr. Lutz commented that the average consumer is not very sophisticated when it comes to reading bar charts and tables, and that the current prospectus requirements include data that many shareholders could never make sense of or understand why it might be important. He noted that the Internet allows more visual communication, and thus the potential for stronger liability protection through clearer communication.

<u>How do investors want to get their information?</u> Mr. Doyle then commented that statistics show that when shareholders seek information relating to laws, policies and regulations, all but the most senior age groups choose the Internet to search for such information. He also noted that while a significant percentage of shareholders (approximately one-third) receive electronic statements, many of these shareholders receive their statements both electronically and in paper. The panelists then discussed the principal reasons why shareholders continue to want paper copies, citing such reasons as the belief that paper is a safer medium (i.e., less susceptible to fraud) and ease of use for record-keeping. The panelists agreed that information security was a critical issue for the fund industry, and was a significant obstacle to increased use of electronic media by fund shareholders. Mr. Lutz noted that information storage was also an issue, and that there was still no perfect electronic storage medium.

<u>What can the fund industry do to improve the usefulness of information provided to shareholders?</u> Mr. Doyle noted that while many investors report reviewing prospectuses before purchasing fund shares, they rank prospectuses below almost every other resource when asked

what they found most useful. The panelists cited several means previously discussed, including the use of prospectus summaries and "layering." Mr. Lutz commented regarding the need for improved websites and information design to help shareholders access the information they are seeking. He encouraged more usability testing on websites, and an increased focus on successful consumer products websites for new ideas. Mr. Downer noted that as long as there are no limitations on the length and content of prospectuses, they will always be too long.

How can the Internet be used to encourage greater use of 401(k) plans by eligible investors? The panelists discussed ways in which the Internet might be used to encourage new investors to make use of 401(k) plans. Mr. Merk commented that investors seem more interested in delegation than self-research, but still want some validation of their purchase and sale decisions. The panelists discussed the related paradox that investors want to be more hands on, but still want professional advice. One panelist suggested that by limiting the amount of information provided to investors through more concise disclosure, fund companies could make the task of investing seem less daunting.

How can the Internet be used to avoid waste? The panelists discussed the striking amount of wasted paper associated with the production of shareholder reports and prospectuses, and observed that the costs of this waste are borne by shareholders in the form of higher operating costs. Suggestions for limiting the amount of waste included more concise disclosure, the use of technology to produce fund-specific prospectuses and reports (as opposed to prospectuses and reports that include information relating to funds the investor does not own and is not interested in purchasing), and increased use of electronic consents and signatures. In light of the significant continued reliance upon (and in many cases, preference for) paper copies, several panelists agreed that using technology to limit paper (e.g., through fund-specific reports) may be a more realistic near-term goal than eliminating paper altogether. Mr. Merk commented that Chairman Cox had stated on several occasions that he was receptive to new uses of technology. Mr. Doyle noted that the fund industry needed to confront investors' suspicions that fund firms' encouragement of electronic media was motivated by profit interest, not a desire to deliver better services to end users.

The panelists offered a number of closing observations, including the likelihood of significant changes in the future use of electronic media by mutual fund shareholders, the likely increased personalization and visualization of content, and the possibility of firms working together to deliver standardized content. Mr. Doyle commented that while it is expensive to redesign websites, he believed that those who lead the way in creating more user-friendly websites with information that is easily accessible and clearly presented will be big winners in asset gathering.

Workshop A: Disclosure Requirements under the Federal Securities Laws

Discussion Leader: Emilie Wrapp, Senior Vice President, Assistant General Counsel, AllianceBernstein Investments

Speakers: Barry Y. Greenberg , Partner, Akin Gump Strauss Hauer & Feld LLP
C. David Messman, Chief Legal Officer, Wells Fargo Funds Management
Janet Olsen, General Counsel, Artisan Partners Limited Partnership

Internet Availability of Proxy Materials. Mr. Greenberg reviewed proposed amendments to the proxy rules regarding internet availability of proxy materials. He noted that, at present, an investment company is required to deliver written proxy materials to all shareholders who have not consented to electronic delivery of such materials. He commented on the increased use of the internet in recent years by investment company shareholders, and noted that the purpose of the proposed amendments was both to reduce the cost of proxy solicitations and to facilitate shareholder activism. He observed that the proposed amendments would require a notice, containing only specified information and a verbatim legend, which may be accompanied by a proxy card, but not by other information (such as a prospectus or periodic shareholder report), to be sent to shareholders at least 30 days in advance of the meeting. The panel discussed the requirement that the issuer respond to shareholder requests for written copies of proxy material within two business days, noting that this requirement would, at least initially, reduce the cost savings associated with the amendments, as investment companies would need to print proxy materials in quantities sufficient to meet all such requests. Mr. Greenberg noted that the ICI had commented on the possibility of requiring some minimum share ownership requirements for reliance on the proposed amendments by shareholders, as well as on the exclusion from the amendments of solicitations in connection with business combination transactions. In response to questions, the panelists expressed the view that the proposed amendments should not affect quorum requirements, adjournment, or other state law matters relating to shareholder meetings.

NASD "Text Box" Proposal. Mr. Greenberg reviewed the NASD's proposed amendments to Rules 2210 and 2211, which would require advertisements containing performance information to include the standardized performance information required by Rule 482, information relating to the maximum applicable sales load and annual fund operating expenses. He noted that in May, 2005, the NASD had filed with the SEC revisions to the proposed amendments that would apply the text box requirement to only printed advertisements, would permit inclusion in the text box of comparative performance and fee data, and would require expenses to be presented gross of any waiver or reimbursement.

Investment Advisory Contract Approval Disclosure. Mr. Messman reviewed the disclosure requirements relating to investment advisory contract approvals and related industry practices that had evolved since the implementation of those requirements. He observed that disclosure relating to directors' consideration of economies of scale tended to be relatively qualitative, and noted the increasing use of breakpoints across the industry. The panelists discussed practices that had evolved regarding review and approval of this disclosure by directors, noting that, because the principal executive and principal financial officers were required to certify as to the accuracy of such disclosure, it was reviewed and approved by directors of most fund groups.

Portfolio Manager Disclosure. Mr. Messman reviewed Form N-1A's disclosure requirements with respect to portfolio managers, noting that "other accounts" managed by the named portfolio managers include accounts managed in their personal capacities. The panelists discussed the disclosure requirements with respect to material conflicts of interest, noting that it might well be appropriate to apply uniform conflict of interest disclosure, particularly for a fund complex with multiple subadvisers, provided that disclosure adequately described such conflicts for each subadviser.

XBRL and Disclosure Reform. Ms. Olsen commented on the relative importance for investment companies of XBRL data tagging of financial information, and noted that the ICI had announced an initiative to develop common XBRL data tagging nomenclature for other information contained in investment company filings that might be more useful to investors (including expense and performance information).

Ms. Olsen also commented on what she perceived to be the three principal obstacles to disclosure reform for investment companies. First, she noted that, under current regulation, it was not clear what fund investors were buying: a pro rata interest in the fund's portfolio securities? the expertise of a particular investment adviser, portfolio manager or team? the ability of particular directors in considering approval of investment advisory agreements? She observed that the lack of a clear consensus as to what fund investors were purchasing made it difficult to determine what should be described in investment company disclosure documents.

Second, Ms. Olsen noted that "disclosure creep," in which responses to comments from SEC staff reviewers resulted in increasingly long and detailed disclosure, continued to be a significant obstacle to disclosure reform.

Finally, Ms. Olsen stated that, absent significant changes to their potential liability, it would be unrealistic to expect investment companies to significantly change their disclosures. She noted that while it was easy to say that a prospectus should be written "the way people talk," oral communication isn't typically held to standards of precision of the type that are relevant in the liability context.

Ms. Olsen commented on the potential of internet-based disclosure to make available to investors, at relatively low cost, the information that each investor wants, without forcing such information on investors who choose not to access it.

Workshop B: Compliance Issues

Discussion Leader: Tamara Salmon, Senior Associate Counsel, Investment Company Institute

Speakers:
Lisa O. Brinkley, Chief Compliance Officer, AIM Investments
Kevin W. Goodman, Assistant Regional Director, Office of Regulation, Pacific Regional Office, U.S. Securities and Exchange Commission
Thomas S. Harman, Partner, Morgan, Lewis & Bockius LLP
John F. Robbins, CFA, Deputy Head of Compliance – Americas, Deutsche Asset Management

The session began with Mr. Robbins and Ms. Brinkley describing the compliance program testing undertaken by their organizations. Mr. Robbins said that he and his colleagues had principally used in-house resources, including internal audit resources, in assigning a score to various policies and functions, and then prioritized their testing based on the scoring. Ms. Brinkley said that her firm relied more on outside resources, having hired a compliance consultant to perform a best practices review and then organized items by risk category.

Mr. Harman said that outside counsel can assist the CCO and the board by helping the CCO understand the board's possible reactions to issues and by helping the board place information from the CCO in the proper perspective.

Mr. Goodman said that the SEC staff was not considering the annual review of compliance policies as an end unto itself, but rather was more interested in knowing that a firm's policies and procedures address the firm's risks and that the firm tests its policies and procedures on a regular basis. He also said that the new rule may limit the SEC's testing in certain instances if the staff finds comfort in the compliance testing that has occurred at an organization, and that the staff, everything else being equal, is more encouraged when firms find and report their own violations than when firms uniformly report clean compliance results. Mr. Goodman said that the SEC staff reviews internal test reports in order to tailor their exams, not to turn them over to their enforcement colleagues. He commented that, although it was conceivable that the staff could determine that an annual report was inadequate, it was more likely that, if an inadequacy existed, the staff would point to the compliance procedures themselves.

Ms. Brinkley discussed her firm's approach to testing external service providers, in this case sub-advisers, saying that on a regular basis her firm receives compliance certificates from sub-advisers and conducts annual on-site visits with respect to its sub-advisers and that each sub-adviser is present at board meetings at least once each year.

Mr. Goodman then said that the SEC staff tries to understand the complexity of the relationship between a firm and its service providers and considers whether the relationship is at arm's-length with an established service provider, in which case the staff would not expect as much in the way of oversight or visits from the CCO. He noted that established service providers often have greater resources to devote to compliance issues than do smaller players or, in some cases, affiliated service providers.

In terms of what constitutes a material compliance issue, Mr. Goodman said that the question should be examined against the backdrop of making sure that the board receives information it needs to effectively oversee compliance. Viewed from this perspective, he said that a lower materiality threshold seems more appropriate than a higher one. He also said that CCOs should not just provide a laundry list of compliance issues to a board, but rather should attempt to prioritize the list for the board.

Finally, after describing the process by which the staff conducts inspections, Mr. Goodman said that the staff no longer routinely asks for emails as part of its initial document requests, but takes a more targeted approach and examines emails if other aspects of the inspection suggest that an email review would be helpful.

<u>Workshop C: Competing Products</u>

Discussion Leader: Andrew J. Donohue, General Counsel and First Vice President, Merrill Lynch Investment Managers

Speakers:
- Jay G. Baris, Partner, Kramer Levin Naftalis & Frankel LLP
- Douglas J. Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission
- Ira P. Shapiro, Associate General Counsel, Barclays Global Investors
- Mary Moran Zeven, Senior Vice President and Senior Managing Counsel, State Street Bank and Trust Company

Mr. Donohue said that the universe of investment products had been characterized by substantial convergence in recent years, as competing products become more like mutual funds and vice versa. He said that the convergence had occurred in three broad areas: in regulation, in the nature of the products being offered, and in the distribution of the products. As to regulatory convergence, he noted the repeal of Glass Steagall, resulting in the sale of investment products of many different types by a single financial services company (often a bank) and its affiliates. He cited the recent efforts by the SEC to regulate private hedge fund managers. He also cited the blurring of traditional investment advisory and broker-dealer activities and related regulatory regimes. As to the nature of the products being offered, Mr. Donohue noted that public funds are engaging in many of the activities traditionally considered the domain of private funds, such as the use of derivatives and short sales, and the rise of exchange-traded funds ("ETFs"), which combine characteristics of traditional actively managed mutual funds with those of traditional index funds. He also noted the recent interest in managed ETFs, which will combine elements of managed mutual funds with elements of typical ETFs.

With respect to convergence in the area of distribution, Mr. Donohue cited as examples registered funds of hedge funds, which combine characteristics of managed mutual funds and hedge funds, making hedge funds – typically privately offered – available to a large, often retail base. He also mentioned interval funds, which combine distribution (and redemption) elements of open-end and closed-end funds.

Ms. Zeven described the sharp increase in the number of ETFs and the amount of assets invested in them. She reviewed the attributes of ETFs and compared them to open-end funds. She noted in particular that only "authorized participants" – typically financial institutions that are members of DTC – are able to buy and sell creation units of ETFs (creation units being blocks of individual shares), through in-kind transactions in portfolio securities. She said that the secondary, exchange-traded market in ETF shares is created through the resale of the shares making up those creation units to smaller purchasers who are not authorized participants. She noted that ETFs generally enjoy quite low expense ratios – generally lower than those of managed index mutual funds – though transactions in their shares generally entail brokerage costs.

In response to a question, panel members said that it was unclear whether ETFs are taking customers away from mutual funds, but they all agreed that there had been a clear increase in the use of ETFs by retail investors. They noted that institutional use had grown, as well, as financial investors use ETF shares for index replication and arbitrage and other index-related strategies. Ms. Zeven noted that many mutual funds are now investing in ETFs, often to gain short-term exposure to one or more securities indexes. She also pointed out that, because ETFs are generally investment companies, the limitations of Section 12(d) under the 1940 Act apply to those investments; she said that many ETF sponsors had been able to obtain exemptive relief from the SEC allowing mutual funds to invest in the ETFs without regard to the 12(d) limitations, provided the ETF and the mutual fund enter into an agreement containing protections for the mutual fund as prescribed by the SEC in the exemptive relief. Panel members explained that, because ETFs are subject to large redemptions at any time by authorized participants, it is often difficult for a mutual fund to determine readily whether its investment in the ETF will violate Section 12(d), making the availability of exemptive relief a key to such investments by mutual funds.

Mr. Scheidt referred briefly to recent exemptive applications relating to actively managed ETFs. He said that the SEC staff is actively looking at those applications, but gave no indication whether or when such relief might be granted. He recognized the general versatility of ETFs, and questioned why more mutual funds do not adopt a practice used by a number of Fidelity sector funds, pricing the funds' shares at multiple times during the day and allowing purchases and sales of fund shares based on the net asset values determined at those times – bringing liquidity more in line with that of ETFs. Mr. Scheidt also expressed his belief that the amount of time it takes to bring an ETF to market is too long and that it would be beneficial to have an exemptive rule, at least covering issues that have generally been resolved to date. (He did not indicate whether the SEC staff is actually working on such a rule.)

Mr. Shapiro then described the attributes of State Street's StreetTRACKS Gold Trust, a grantor trust, which he noted is not regulated as an investment company and does not need to comply with sub-chapter M of the Internal Revenue Code. He also described a new Deutsche Bank product, which is an ETF that invests exclusively in a managed commodity pool. He noted that that product was not registered under the 1940 Act, but that sales of its shares do generally need to be registered under the 1933 Act, and the fund itself is required to comply with registration requirements under the 1934 Act.

Mr. Shapiro also described collective investment trusts, generally sold only to qualified retirement plans. He said that these trusts are regulated principally under banking laws. He cited the flexibility of the trusts, noting that they can allow for variability in pricing among investors and that they do not generally need to comply with federal disclosure requirements and other requirements applicable to registered funds. He noted that some fiduciaries might prefer to invest in a registered fund in order to gain the benefits provided by the 1940 Act, but that for many retirement plan sponsors and trustees, collective trusts offer a more flexible, less expensive alternative.

Mr. Scheidt noted that, in some cases, a single sponsor will form a registered and an unregistered investment vehicle, where the unregistered vehicle is able to avoid registration due to the nature of its investments – for example, a fund investing exclusively in gold bullion. He said that a registered version of that same vehicle might be considered an investment company because the fund invests a portion of its assets in U.S. Government securities (thereby meeting the minimum required investment in "securities"), while achieving essentially the same investment return as the unregistered fund through investments in various derivatives. He questioned whether it was appropriate for that fund to register under the 1940 Act – and then said he would "leave it at that."

Mr. Baris described generally the recent growth in assets invested in separately managed accounts. He described the nature of such accounts generally, including so-called unified managed accounts ("UMAs"), which can invest in many different asset types, including hedge funds, funds of hedge funds, ETFs, single securities, etc. – potentially creating a product-within-a-product-within-a-product. Mr. Donohue noted that separately managed accounts, ETFs, structured notes, and other new financial products give brokers great flexibility to design portfolios for clients, blurring the line between investment advisory and brokerage services. He noted that, if mutual funds are subject to an incremental level of regulation, including point-of-sale disclosure and record-keeping requirements, those other products may well become products of choice for brokers.

Mr. Baris discussed the growth of investor interest in “portable alpha,” meaning generally the value-added return over and above an index return. He noted that he might expect investors to choose inexpensive index-replication products, such as ETFs, to create their “beta”-oriented portfolios, and will pay enhanced fee levels only to managers who can provide the desired alpha.

In response to a question, Mr. Scheidt acknowledged that the limits on advertising and promotional activities that apply to privately offered hedge funds (such as those that arise under the 1933 Act) limit the transparency of hedge-fund investing and contribute to the mystery surrounding those products. He noted, however, that there is no easy solution to the issue under existing law, and that there appears to be little interest among policy makers to change the law to ameliorate the situation.

Mr. Scheidt noted suitability concerns relating to separately managed accounts. He noted that many separately managed accounts are more expensive than mutual funds offering the same investment discipline. In his view, if an investor really wants the customization and tax-efficiency a separately managed account may provide, then such an investment vehicle may be appropriate for that investor; but such an account may offer few benefits not offered by the comparable mutual fund at an increased cost.

Mr. Shapiro then offered a few general thoughts regarding ETFs. He said that Barclays markets ETFs principally to advisors for use as part of an asset allocation program for clients. He said that the funds are used by self-directed investors as well, but that that is not Barclays’ principal intention in developing the products. He also said that Barclays does not believe that actively managed ETFs will offer the transparency that will be necessary in order to ensure the necessary arbitrage activity to eliminate market discounts/premiums.

Workshop D: Tax Issues

Discussion Leader: Keith D. Lawson, Senior Counsel, Investment Company Institute

Speakers:
Ronald S. Cohn, Tax Partner, Ernst & Young LLP
Clarissa Potter, Special Counsel to the Chief Counsel – Legislation, Internal Revenue Service
Catherine A. Taylor, Counsel, Ameriprise Financial Services
Jon W. Zindel, Vice President - Director of Tax and Financial Reporting, American Century Investments

Federal Legislative Developments. *Foreign Investment in Real Property Tax Act (FIRPTA) Provisions (S.2020, Sections 563-56)).* Mr. Lawson emphasized certain favorable changes lessening the likely application to regulated investment companies (RICs) of the FIRPTA provisions enacted by the American Jobs Creation Act of 2004. In particular, the new proposed provisions would limit FIRPTA’s application to those funds with more than half of their investments directly or indirectly in U.S. real estate, and capital gain distributions by such a fund would not be “FIRPTA gain” subject to tax filing requirements unless the foreign shareholder owns more that 5 percent of the fund (this is the rule that currently applies to REIT investors). Such gain would nonetheless be treated as ordinary income.

Mr. Lawson next mentioned the *GROWTH Act* (H.R. 2121, S.1740), that, consistent with a popular understanding that capital gain taxes are not due until you sell the investment, would allow mutual fund investors to defer the tax in all reinvested capital gain distributions until the shares were redeemed.

Simplification Through Additional Reporting Tax Act (or "START" Act (S. 2114): Basis Reporting for Securities. Ms. Taylor reviewed some of the START Act provisions that would impose on brokers the obligation to provide shareholders with information about their tax cost ("basis") in their mutual fund shares, applicable to securities (including mutual fund shares) purchased after 2007. Ms. Taylor pointed out that while in theory brokers are in a position to know a shareholder's basis in his or her fund shares, there are a number of exceptions to the normal rules relating, for example, to gifted shares, transfers between spouses, inherited shares, so-called wash sales and corporate action(s) that complicate this and make it difficult for a broker to be able to provide such information reliably.

Regulatory Developments. Mr. Cohn reviewed Revenue Ruling 2006-1, to the effect that swap contracts entered into by a fund seeking exposure to commodities equal to the principal value of the fund did not generate income qualifying under Code Section 851(b)(2) (or "good" income). He pointed out that the IRS did not necessarily conclude in that ruling that swap contracts were not 1940 Act securities, but rather simply observed that there was no "conclusive authority" to such effect, and thus they were not within the intent of the cross-reference to the definition of 1940 Act securities in the 1986 Act. Mr. Cohn pointed out that this approach has the practical effect of locking the interpretations of the 1940 Act into interpretations that are now twenty years old, given that the only clear blessings that were provided in the legislative history related to stock index futures and other derivative contracts relating to stocks and securities.

Mr. Lawson then talked about the recent, quite pervasive, mistake that funds made by incorrectly reporting foreign tax credits to their shareholders, including under the U.S.-U.K. Treaty (the relevant provision of which changed in 2004), Singapore and Malaysia, and the funds' efforts to straighten the situation out.

State Tax Reporting. Mr. Zindel talked about a proposed California regulation that would apportion income of mutual fund service providers based on the location of shareholders. More optimistically, he also referred to the proposal now being considered by the Senate Judiciary Committee that would extend principles of so-called Public Law 86-272 exempting from state taxation, the activities of sellers of tangible personal property that are limited to certain *de minimis* threshold within a state, to all service providers, including mutual fund service providers.

Workshop E: ERISA and Retirement Issues

Discussion Leader: Mary Podesta, Senior Counsel, Investment Company Institute

Speakers: Catherine L. Heron, Senior Vice President, Fund Business Management Group, Capital Research and Management Company
Lisa H. Lattan, Vice President and Assistant General Counsel, J. P. Morgan Retirement Plan Services
Donald J. Myers, Partner, Reed Smith, LLP

This workshop examined (i) several significant legislative developments, including developments relating to investment advice to retirement plans, EGTRRA permanence, prohibited transaction reform, automatic enrollment, mapping of investment options and diversification, (ii) the current agenda of the Department of Labor and (iii) current tax policy and the current agenda of the Internal Revenue Service.

Legislative Developments. The panel first discussed certain provisions of the Pension Protection Act of 2005, which was passed by the House of Representatives, and the Pension Security and Transparency Act of 2005, which was passed by the Senate, focusing on provisions in the bills that encourage the provision of investment advice to participants in defined benefit plans. As described by the panel, the House bill provides an exemption from the prohibited transaction rules to allow service providers to provide advice to participants in plans they serve, but the Senate bill only provides fiduciary relief for plan sponsors that contract for independent investment advice for plan participants.

Ms. Heron discussed the House bill's provisions to make permanent the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), which is currently set to expire after 2010. She reported that it is likely that EGTRRA will be extended beyond its current expiration date.

The panel then discussed prohibited transaction reform in the bills. Mr. Myers discussed cross trading, which is the practice of a manager matching trades between its managed accounts. He reviewed Section 406(b)(2) of ERISA, which, in effect, prohibits a fiduciary from acting on both sides of a transaction and therefore engaging in cross-trading with its benefit plan accounts. Mr. Myers reported that the Senate bill commissions a study to be undertaken on the implications for pension plans of providing a prohibited transaction exemption for "active" cross trades. He also stated that the House bill has no provisions on cross-trading. Mr. Myers then addressed the plan asset rules for pools of assets and the provisions of the House bill that would amend Section 3 of ERISA to provide a statutory exception to the plan asset rules if less than 50% of the total value of each class of equity interests in an entity (the current rule is 25%) are held by employee benefit plan investors, as redefined to only include U.S. benefit plan investors. Mr. Myers then reported that there is more sympathy for changing the definition of benefit plan investor than to change the percentage from 25% to 50%.

Ms. Lattan discussed the provisions in the House and Senate bills relating to automatic enrollment and mapping. She reported that the provisions in the bills relating to automatic enrollment are not particularly controversial. She then stated that the general framework for the concept is to allow plan sponsors to automatically enroll employees in the retirement plan unless they opt out during a certain opt out period. She also noted that the ability for plan sponsors to automatically enroll employees has existed for some time but that sponsors have not embraced the idea due to some lingering concerns, which the Senate and House bills attempt to alleviate. The first concern, Ms. Lattan said, is whether automatically enrolling an employee violated state wage withholding or other state laws. According to Ms. Lattan, the House and Senate bills attempt to alleviate this concern by explicitly preempting state laws that would otherwise prohibit automatic enrollment, provided that the plan meets certain notice and contribution requirements. The second concern, according to Ms. Lattan, is the possibility of having many accounts with very small balances due to employees noticing the automatic enrollment and then terminating the withholding. Ms Lattan reported that the bills attempt to address this issue by permitting withdrawals from small accounts if the employees have only been enrolled for a short period of time. The third issue revolves around how an employer should invest the money of participants who are automatically enrolled in the plan. Ms. Lattan noted that under current laws, the protection in ERISA Section 404(c) is available only if an employee makes the affirmative investment decision, which would not be the case if they were automatically enrolled. To alleviate this concern, Ms. Lattan reported that the House and Senate bills would amend Section 404(c) to provide that a participant in a plan that meets certain notice requirements is treated as exercising control over the assets in the account that are invested in accordance with DOL regulations, making the protections in 404(c) available to plan fiduciaries.

Ms. Lattan next addressed the provisions in the House and Senate bills relating to mapping of investment options. She reported that the bills, in different degrees, provide protection to fiduciaries for changes in a retirement plan lineup as long as certain requirements are satisfied. She noted, however, that neither bill provides protection if a fiduciary eliminates, as opposed to changes, an investment option. Finally, Ms. Lattan discussed certain provisions in the Senate bill that add certain diversification requirements to individual account plans that invest in employer securities or employer real property.

DOL Agenda. The panel next discussed the DOL's current agenda. Mr. Myers briefly discussed LM-10 reporting and the June 2005 interpretation by the DOL that, for the first time, raised the issue of LM-10 reporting by investment management organizations who provide gifts or favors to union officials that serve as Taft-Hartley plan trustees or officers.

Ms. Lattan discussed fee disclosure issues at the plan sponsor level and the plan participant level. She discussed the ERISA Advisory Council Report of the Working Group on Plan Fees and Reporting on Form 5500, which recommended that (i) the DOL modify Form 5500 so that total fees incurred directly or indirectly by a retirement plan could be reported, (ii) all fees paid to plan providers, including "revenue sharing fees," should be reported or estimated on the form and (iii) the DOL revise its model 401(k) plan fee disclosure to help plan sponsors better capture all indirect or non-explicit fees. She also reported that, with respect to plan participants, as recommended by the ERISA Advisory Counsel Report of the Working Group on Fee and Related Disclosures to Participants, if a sponsor wants Section 404(c) protection: (a) employees should receive profile prospectuses for each investment option upon eligibility to participate in the plan, (b) at such time participants should also be given explanatory materials, (c) annual statements to participants should include the expenses of each investment expressed as a ratio and other information, as well as identification of any investment expenses paid by the plan sponsor and (d) the DOL should provide a model. Finally, Ms. Lattan commented that a fee can not be reasonable under Section 408(b)(2) under ERISA (which provides that services to an ERISA retirement plan are permitted only if the compensation for such services is reasonable) if it is not disclosed to the plan sponsor. Mr. Myers then commented that investment advisers need to make sure that all fees are disclosed to the plan fiduciary. The panelists then discussed whether all of the components of the fee needs to be disclosed as opposed to just disclosing an aggregate amount.

Ms. Lattan next discussed DOL Advisory Opinion 2005-23A, which distinguishes between when someone is and is not deemed to be providing advice in the retirement plan context. Ms. Lattan stated that this DOL Advisory Opinion stands for the proposition that an adviser who is selected by a participant to manage the participant's investments in a qualified, participant-directed retirement plan is a fiduciary, unless the adviser is merely advising the participant to take a distribution from a retirement plan, in which case this advice does not make the adviser a fiduciary even if the advice is combined with a recommendation for investing the assets to be distributed.

Current Tax Policy and IRS Agenda. Ms. Heron briefly reviewed the Bush tax reform proposals and the new Roth 401(k) and 403(b). Ms. Heron reported that she does not expect the Bush reform proposals to gain any momentum in the near future. With respect to the Roth 401(k) and 403(b), Ms. Heron commented that employers and consumers are not embracing them because the system (i) has become too complicated, (ii) is a burden on plan sponsors and (iii) is currently set to expire in 2010.

The Regulatory Outlook for Mutual Funds

Moderator: Elizabeth R. Krentzman, General Counsel, Investment Company Institute

Speakers: Barry Barbash, Partner, Wilkie Farr & Gallagher LLP
Michael H. Koonce, General Counsel, Evergreen Investments
Susan Ferris Wyderko, Acting Director, Division of Investment Management, U.S. Securities and Exchange Commission

Ms. Krentzman began the discussion by noting that the current regulatory and technological environments offer a unique opportunity for the mutual fund industry and the SEC to develop new approaches to disclosure, and that she looked forward to working with the industry and regulators in doing so.

Current Regulatory Priorities. Ms. Wyderko provided a general outline of the current regulatory priorities of the Division of Investment Management. She noted that investors need to be able to make informed investment decisions, and that disclosure is an important priority for the Division. She said that this is a "transition period to new forms of communication," and that Chairman Cox is committed to the development of the Internet as a means for good disclosure, and hopes to "leverage the power of the Internet" for this purpose. In her view, technology and the Internet can provide investors with more choices as to which information they receive and in what format, and she cited to SEC initiatives in tagging data, developing XBRL, and encouraging "layered" disclosures. She was quite complimentary of industry usage of websites, saying the SEC does not want to stand in the way of development of web-based dissemination of information, but rather wants to facilitate it.

Ms. Wyderko noted that the Division's resources had been strained in recent years as it has struggled to develop and implement new rules in response to what she called the "frenetic environment" in recent periods. She said that, with much of that work behind the staff, it is time to reassess those rules, and to ask whether they are working. She also acknowledged that the exemptive process needed to be reviewed to assure that it is working properly and timely.

Disclosure Methodologies. On the topic of disclosure generally, Mr. Barbash agreed that the Internet has been and would likely continue to be a helpful disclosure tool. He did note, however, that practitioners need to view developments in disclosure methodologies in light of the potential liabilities they might create, and noted that he suspected there is little that the SEC or its staff will be able to do to provide industry participants comfort on difficult liability issues.

Mr. Koonce said that he was not convinced that the developments in filing technologies allowing investors to retrieve discrete data points from SEC filings will necessarily be especially helpful to mutual fund investors. Aside from fee and performance information, he believes that there may be little data in mutual fund filings that is of particular interest to individual mutual fund investors. He wondered whether data tagging and other technologies might be more helpful to investors in 1934 Act reporting companies, whose filings generally contain more detailed financial reporting information. He also cautioned against "force-feeding" investors types and amounts of information they do not necessarily want or need. He said that some disclosures that are currently required in every mutual fund prospectus (such as information regarding calculation of net asset value and shareholder services of various types) are generally of little interest to most investors, but investors are required to receive those disclosures as part of every prospectus. He said that he believed that much of that information should be made available to investors on the Internet or in writing on request, but should not necessarily be included in all prospectuses.

Point-of-Sale Disclosure. Ms. Wyderko reported that the staff expects that, toward the middle of this year, the Commission will repropose its point-of-sale rule, which applies to disclosures to be made in connection with the sales of variable products, 529 plans, and mutual funds. She said that the staff had done a substantial amount of further thinking about the rule in light of comments received, and that the revised rule would be significantly different from the original proposal. She noted that the staff does not want to encumber the sales process. Panelists observed that it was not at all clear that the rule's scope should be limited to variable products, 529 plans, and mutual funds, but should potentially apply to other products such as separately managed accounts. They pointed out that otherwise the rule could put mutual funds at an unfair competitive disadvantage compared to other products, because brokers will choose to sell the less highly regulated products. They also noted that, if the rule has been substantially rewritten, the industry should be given a substantial amount of time to comment on the rule as reproposed. Ms. Wyderko said that the staff will be looking to apply the point-of-sale rule to other investment products in the future, but that the staff's thinking in this area is most advanced as to variable products, 529 plans, and mutual funds.

Redemption Fees. Mr. Koonce said that he considered Rule 22c-2 to be controversial and disruptive and arduous to implement. He noted how different the final rule is from the one the SEC adopted, and said that he thought the final rule suffered from the SEC's failure to seek industry comment on it before adopting it. Ms. Krentzman noted that the process of adopting the rule in fact moved very quickly and caught many in the industry off-guard. She said that the problems with the rule and the related industry dissatisfaction show the importance of the public comment process.

Mr. Barbash commented that one of the problems with the rule and its adoption is that the rule relates substantially to mutual fund operations and distribution, areas with which the SEC and its staff have a relatively limited familiarity. He wondered whether the industry really needs Rule 22c-2. He noted that the rule was adopted in response to the market-timing scandal, but that, since that time, improvements in fair value pricing and frequent-trade monitoring have limited the ability of investors to engage effectively in market timing. Mr. Koonce wondered whether it was really worth the many billions of dollars implementation of the rule will require to ferret out the last few market-timers. Mr. Barbash also said that the rule puts mutual fund directors in a difficult position, because the rule seems to imply that redemption fees are a good thing, and that directors who disagree may feel they are at odds with the SEC.

Ms. Wyderko acknowledged that the rule was adopted in an environment where the SEC and the staff were under great pressure to respond to the market-timing scandal and that there had been significant industry developments to limit market-timing since 2004. She said, however, that the SEC had adopted the rule, that Chairman Cox has stated his commitment to the rule and that the staff will continue to take steps toward its implementation. She clarified that the rule should not be read to reflect any bias by the SEC or the staff in favor of redemption fees. Ms. Krentzman concluded the discussion of the rule by encouraging the SEC to extend the compliance date beyond October 16, noting that, especially in light of the fact that the rule will likely be amended between now and then, compliance by that date will be difficult to achieve.

<u>Exemptive Application Process</u>. Ms. Wyderko then turned to the subject of the exemptive application process, and acknowledged that the Division needs to review the process, to determine especially whether the process is taking too much time. She indicated that the staff was looking at ways to streamline the exemptive process for unmanaged exchange-traded funds. She noted, however, that actively managed ETFs need to be viewed "holistically" in light of other actively managed products. She said that the issues raised by actively managed ETFs will not be "conclusively adjudicated" in a time frame "on the near horizon." She said that the staff continues to work on the hard-close rule, and was evaluating the rule in light of market-based solutions that have been developing. She said that the staff continues to consider issues relating to Rule 12b-1.

Mr. Barbash emphasized the importance of resolving the delays in the exemptive process. He noted that the exemptive process is where the industry innovates and that a failure by the SEC to respond to exemptive requests may have the effect of stifling innovation. Ms. Wyderko said that the staff had been focused on other regulatory priorities in recent years, limiting its ability to deal with exemptions. She reiterated that it is her intention to focus on issues in the exemptive process in the near future.

Panelists closed the discussion of the exemptive process by noting difficulties in the no-action process and the apparent fear on the part of the staff that the no-action process may lead to ad hoc rulemaking. Ms. Wyderko noted that that issue is a difficult one and the subject of much current internal debate at the SEC.

<u>Issues Facing Fund Directors</u>. Mr. Koonce noted three issues: (i) directors' responsibilities have increased significantly, without much guidance from the SEC as to how to meet those responsibilities (he cited specifically the lack of guidance as to fair valuation and soft dollar review); (ii) informal guidance from the staff in letters and telephone calls is unhelpful, since there is no comment process and industry participants do not know whether or to what extent it is advisable to rely on informal guidance; and (iii) many responsibilities required to be performed by directors might now be performed as well or better by fund chief compliance officers (such as review of transactions under Rules 10f-3, 17a-7, and 17e-1, and compliance with Rule 2a-7).

Mr. Barbash appeared to like the idea that CCOs might perform some of those obligations, but noted that he thought the staff would not likely embrace the idea. He noted that many boards have now become more aggressive with fund management, have more meetings, and are less likely than before to put up with poor performance. He noted, however, that many directors feel that they are suffering from "information overload," and are not sure which elements of oversight are theirs and which might be left to CCOs. He said directors are looking to receive less detailed information and to obtain guidance from the SEC as to what role they should now be playing vis-à-vis fund management and fund CCOs. He said that, in the absence of guidance from the SEC or its staff, the ICI and the industry should work to set some standards in these areas.

Ms. Krentzman also noted that many directors now feel that their regulatory responsibilities leave them little time to oversee the general investment process, a very important element of their oversight responsibilities.

Panelists noted that many directors are concerned about the annual contract approval process, citing statements by the SEC and its staff in recent periods to the effect that directors might, in the course of the 15(c) process, more actively consider whether it is desirable to replace a fund's advisor in response to a period of bad performance or high relative expenses. Panelists noted that mutual funds are already at a disadvantage to other types of investment products, in light of the high degree of regulation and expense involved in their organization and operation. They noted that an enhanced risk that the sponsor might unexpectedly lose its advisory contract in connection with the 15(c) process might be a great deterrent to new entrants into the public fund industry.

Ms. Krentzman encouraged the staff to consider carefully the relative costs and benefits of its regulatory initiatives, in light of the fact that what might appear to be a good idea from a regulatory perspective might be unduly costly to implement in light of the benefit achieved. Ms. Wyderko said that the staff performs a detailed cost-benefit analysis of all new rules (she cited the cost-benefit analysis included in the adopting release for Rule 22c-2), but said that cost-benefit analyses are time intensive and strain staff resources.

Ms. Krentzman wrapped up the panel discussion by reiterating her view that the current environment provides a unique and favorable opportunity for the industry and the SEC staff to work together to improve and streamline the disclosure process.

Panel 1-A: Brokerage Issues

Moderator:	Marguerite Morrison, Managing Director and Associate General Counsel, New York Life Investment Management
Speakers:	Ari Gabinet, Principal – Securities Regulation, The Vanguard Group Stephanie M. Monaco, Partner, Mayer Rowe & Maw LLP Robert Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission

Ms. Morrison discussed the SEC's proposed interpretive release on the use of soft dollars under Section 28(e) of the Securities Exchange Act of 1934. Mr. Gabinet pointed out that investment advisers' use of soft dollars raises issues that have been the subject of widespread debate and criticism for many years. He stated that the negative portrayal of soft dollars had led the industry to rephrase such practices as "client commission arrangements."

Ms. Monaco reviewed the history of soft dollars, including the need for brokers to distinguish their services. She discussed the deregulation of the brokerage commission structure and the adoption of Section 28(e) in 1976 and reviewed abuses of the safe harbor provided under Section 28(e), which was followed by additional interpretive guidance from the SEC. Ms. Monaco then reviewed the recent release, noting that it provides guidance with respect to: (i) the appropriate framework for analyzing whether a particular service falls within the "brokerage and research services" safe harbor, (ii) the eligibility criteria for "research," (iii) the eligibility criteria for "brokerage," (iv) the appropriate treatment for mixed-use items, (v) a money manager's statutory requirement to make a good faith determination as to the reasonableness of the commissions paid, and (vi) third-party research and commission sharing arrangements.

As to what constitutes eligible research, the panel noted that the release states that an adviser must conclude that the product or service reflects the expression of reasoning or knowledge and relates to the subject matter identified in Section 28(e)(3)(A) or (B). Items ineligible to qualify as research – products or services that do not reflect the expression of reasoning or knowledge – include products that fall into the category of overhead expenses. In response to a question from Ms. Monaco, Mr. Plaze stated that the release was issued to offer the industry additional advice on the subject matter and was meant to elaborate on the SEC's guidance issued in 1986.

The panel discussed the proposed guidance with respect to "mixed-use" items, noting that the release states that the SEC continues to believe that the mixed-use approach is appropriate. Mr. Gabinet referred to footnote 108, pointing out that if an adviser receives both eligible and ineligible products, the adviser must determine what is ineligible under the safe harbor provision and must pay for that portion of the commission.

Ms. Monaco discussed the exclusion in Section 202(a)(11)(C) under the Investment Advisers Act of 1940, which excludes from the definition of investment adviser any broker-dealer whose services are incidental to the conduct of its brokerage business and who does not receive special compensation for such services. She noted that, in April 2005, the SEC adopted Rule 202(a)(11)-1, providing an exception from the definition of investment adviser for certain broker-dealers providing non-discretionary advice that is solely incidental to their brokerage services. She then discussed the no-action letter that was subsequently issued to the Securities Industry Association and noted that while others in the industry were pleased with this letter, she was not. In particular, she discussed the difficulty surrounding the interpretation of advice "solely incidental" to the conduct of business as a broker-dealer and the interpretation of special compensation.

Mr. Plaze explained that broker-dealers differentiate between advisory clients and brokerage clients. He discussed the adoption of Rule 202(a)(11)-1 and the resulting explosion of reliance on the Rule. Discussion followed regarding who would be considered the broker's client when a broker provided unbundled research to an investment adviser, during which Mr. Plaze stated that the broker's client may be the investment adviser, rather than the investment adviser's client.

Turning next to the allocation and aggregation of client orders, the panel emphasized the need for procedures. A discussion ensued regarding the sequencing of client orders and the need for an adviser to meet its fiduciary obligations. The obligation to disclose brokerage practices was discussed, and Mr. Gabinet expressed his opinion that disclosure was not a cure for systematically disadvantaging one client over another. Mr. Plaze noted that accurate and complete disclosure is required to meet the minimum requirements of the Adviser's Act. He added that an adviser is relieved of its best execution requirements in directed brokerage arrangements only when it is disclosed to the client that best execution will not be achieved. Mr. Plaze pointed out, however, that regardless of meeting the minimum standards of the Adviser's Act, the best business decision for an adviser may very well be to execute client directed orders in a manner that gives all clients a chance of achieving best execution.

Lastly, the panel discussed a board's role in reviewing an adviser's fulfillment of best execution practices. The panel discussed the use of external vendors to compare an adviser's execution costs with those of its peer firms and the use of forensic testing to examine the allocation of trades.

Panel 1-B: The Relationship Between Funds and Intermediaries

Moderator: Robert M. Zakem, Executive Director, UBS Financial Services

Speakers: Joseph P. Savage, Associate Vice President, Investment Companies Regulation, NASD
C. Hunter Jones, Assistant Director, Division of Investment Management, U.S. Securities and Exchange Commission
Phillip S. Gillespie, Senior Vice President and Deputy General Counsel, OppenheimerFunds
Bruce G. Leto, Partner, Stradley Ronon Stevens & Young, LLP

Mr. Zakem opened the presentation by observing that intermediaries are critically important to the mutual fund business, because "nobody makes any money unless something gets sold."

Revenue Sharing and Other Payments Between Fund Companies and Intermediaries. Mr. Leto reviewed recent revenue sharing cases and regulatory settlements against both fund advisers and brokerage firms. He noted that the basis of these cases was (1) with respect to advisers, a failure to make appropriate disclosures to fund boards, and to investors through fund prospectuses/registration statements, of "revenue sharing" payments the advisers were making to brokerage firms and (2) with respect to brokerage firms, a failure to make adequate disclosure to customers of compensation the brokerage firms were receiving in connection with the sale of fund shares.

Mr. Leto noted that a condition of some of the settlements against advisers was that the fund board have a larger role in overseeing the adviser's revenue sharing payments to brokers. Mr. Leto recommended that, in their requests under Section 15(c) for information relating to advisory and underwriting agreement approvals, boards should ask for detailed information regarding any revenue sharing arrangements the adviser has with brokers that sell shares of the funds.

Mr. Gillespie noted that OppenheimerFunds' revenue sharing settlement requires the adoption of a written policy regarding revenue sharing and quarterly and annual reporting on the matter to the fund board. He characterized this as a "wonderful" development for the fund industry.

Mr. Zakem asked the panelists whether greater transparency of revenue sharing arrangements to fund boards would lead boards to seek reductions in advisory fees. The consensus of those panelists who responded to the question was that revenue sharing is an important element of the mutual fund business that boards should seek to understand, and that boards should know both the amounts that the adviser pays in revenue sharing and the formulas used to determine the adviser's payment to each recipient brokerage firm.

Mr. Jones said that the SEC staff is still considering what disclosure of revenue sharing arrangements should be required, in conjunction with the "point of sale" disclosure rule, which, he said, the SEC intends to repropose.

Mr. Savage said that an NASD task force of representatives from both the mutual fund and the broker-dealer communities has recommended the use of a document that he called a "profile plus." This is a 2-page disclosure document that would be delivered electronically by a broker to its customers when they buy a mutual fund. The document contains summary information regarding the fund, plus information regarding conflicts of interest faced by the brokerage firm in connection with selling mutual fund shares. The document would also contain electronic links to other sources of information, including the fund prospectus.

It was the consensus of panel members that revenue sharing arrangements do not conform to any one pattern and are unlikely to become standardized in the foreseeable future.

Mr. Zakem observed that revenue sharing "levelizes the economics between a low margin business (brokerage) and a high margin business (asset management)."

Messrs. Jones and Zakem noted that there are many different types of payments made by fund companies to intermediaries, including

- Revenue sharing
- Networking fees
- Administrative services fees
- Sub-transfer agency fees and
- Third party administration fees relating to retirement plans

It was noted that, in some instances, some of these kinds of payments may be made out of the assets of the funds themselves, and that fund boards should already be giving close attention to payments to intermediaries that are made out of fund assets.

<u>Short-Term Trading and Redemption Fees</u>. Mr. Jones summarized the proposed amendments to Rule 22c-2, which were released by the SEC on February 28 (see Rel. No. IC-27255). He said that the amendments were intended to clarify the following matters:

- Who is a "financial intermediary"
- How to deal with "chains of intermediaries" and
- What to do if no agreement is in place with a particular intermediary

He noted that the compliance date for Rule 22c-2 remains October 16, 2006. Comments on the proposed amendments are due by April 10. So far, Mr. Jones said, the SEC has received one comment letter, requesting that the compliance date be postponed. Mr. Jones said that commenters who urge a delay in the compliance date should be specific as to how long a delay they believe is appropriate.

Mr. Gillespie noted that the ICI has issued a useful Rule 22c-2 compliance package that contains suggested forms.

Mr. Savage said that the NASD had recently cautioned its members that a broker-dealer that violates the terms of its selling agreement with a mutual fund group might thereby violate NASD rules. He said that the pronouncement was intended to reiterate that a broker-dealer's use of deception or subterfuge to circumvent a fund's anti-market timing policies would violate NASD rules.

Mr. Zakem expressed skepticism that the industry is technologically incapable of applying a redemption fee on omnibus account participants.

Mr. Gillespie noted the view, which has been attributed to some state insurance regulators, that a redemption fee imposed by a mutual fund that is the underlying investment vehicle for variable annuities or insurance contracts may violate the terms of insurance contracts that permit redemptions or exchanges free of charge. He said that the better view is that the redemption fee is imposed by the fund, and is therefore not controlled by the terms of the investor's insurance contract.

The panel discussed the likelihood that intermediaries will seek to charge fund companies for providing the information required under Rule 22c-2. Mr. Jones said that the SEC's cost/benefit analysis of the Rule had assumed that there would be such charges.

The panel also discussed the ambiguity under the Rule as to whether an account maintained by an intermediary should be regarded as an omnibus account or as a single investor, for purposes of a fund's application of its redemption fee. Mr. Jones said that funds can treat an omnibus account as a single investor, and apply the redemption fee at the account level rather than at the level of the underlying beneficial owners. In such a case, an intermediary agreement would not be required.

<u>Uses of Distribution Fees</u>. Mr. Leto summarized the SEC staff's November 30, 2005 no-action letter to E*Trade Securities, which took a no-action position with respect to a broker-dealer's plan to rebate a portion of its 12b-1 fee receipts to its customers who invest in mutual funds that make Rule 12b-1 payments to the broker-dealer. He noted that, in the letter, the SEC staff said that a fund's board "should consider broker-dealer rebates of the fund's 12b-1 fees as a pertinent factor" in the board's evaluation of the continuation of the fund's 12b-1 plan. The E*Trade no-action letter clarifies the earlier Mahaffy no-action letter (March 17, 2003). In E*Trade, the staff specifically stated that Mahaffy should not be read to say that, if a broker-dealer rebates a portion of the 12b-1 fees it receives, the fund's board could never determine that there is a reasonable likelihood that the 12b-1 plan would benefit the fund and its shareholders.

Mr. Leto suggested that, in their requests under Section 15(c) for information relating to advisory and underwriting agreement approvals, fund boards should ask for detailed information regarding the adviser's and principal underwriter's knowledge of the extent, if any, to which dealers in the funds' shares are rebating their 12b-1 revenues to their customers.

Mr. Gillespie noted that intermediaries make rebates of a portion of their 12b-1 or shareholder servicing revenues for a variety of reasons, including to avoid possible "double-dipping" concerns under ERISA or other fiduciary law principles. Mr. Zakem observed that a variety of kinds of rebates have existed for many years, and that, therefore, the issues raised by the Mahaffy and E*Trade letters are not novel. Mr. Jones said that, if a fund or an affiliate of the fund is the party that makes the rebate, the rebate may present a senior security issue under Section 18 of the Investment Company Act.

Panel 1-C: Corporate Governance and Shareholder Activism

Moderator: Eric Roiter, Senior Vice President and General Counsel, Fidelity Management and Research Company

Speakers: Sanjai Bhagat, Professor of Finance, University of Colorado
Amy Goodman, Partner, Gibson, Dunn & Crutcher LLP
John Wilcox, Senior Vice President, Head of Corporate Governance, TIAA-CREF

Mr. Roiter said that this panel was intended to stimulate, rather than influence, thinking about corporate governance and shareholder activism. He said that the panelists would, for purposes of the discussion, accept the principle that active mutual fund managers intended to maximize their funds' economic returns, and would explore whether adopting an activist position in proxy voting would assist mutual fund managers in achieving this goal

Research into Corporate Governance Measures. Prof. Bhagat reviewed his recent research into the correlation of various measures of corporate governance with increased shareholder returns. He began by reviewing several well-known indices of corporate governance developed in previous studies, including:

- the G-Index (developed by Gompers, Ishii and Metrick in 2003, and based on the number of shareholder rights-decreasing provisions a firm has implemented, such as poison pills, golden parachutes, supermajority rules to approve mergers, staggered boards, and limitations on shareholders' ability to call special meetings); and
- the E-Index (developed by Bebchuk, Cohen and Ferrell in 2004, and based on the number of management-entrenchment provisions a firm has).

He said that stock ownership by a "median" board member was also a good index of corporate governance. Prof. Bhagat said that previous research suggested that good corporate governance, whether measured by G-Index, E-Index or stock ownership of board members, leads to better current and future performance.

Prof. Bhagat commented on the general policy in favor of enhanced board independence. He then said that his own research demonstrated that board independence is negatively related to a company's operating performance. He observed that this phenomenon may be explained by struggling companies seeking independent directors to serve on their boards to a disproportionate degree. Mr. Roiter observed that if struggling companies tended to have more independent directors, one could expect the average stock ownership of directors to decline relative to a board more populated with insiders.

Prof. Bhagat said that he also tested the idea that, in a well-governed company, CEO turnover should increase following a period of poor performance. He said that his results indicated that disciplinary management turnover in poorly performing companies was correlated with director stock ownership and with board independence, but not with the G-Index or E-Index.

Based on his findings, Prof. Bhagat recommended (i) that efforts to improve corporate governance focus on increasing the stock ownership of board members, which he said correlated positively with both future operating performance and the probability of disciplinary management turnover in poorly performing firms, and (ii) that proponents of board independence should note with caution the negative relation between board independence and future operating performance.

Mr. Wilcox then said that TIAA-CREF considered itself, as a long-term owner of shares of companies, to have monitoring responsibilities. He said that TIAA-CREF was typically concerned with matters such as shareholder rights and governance and executive compensation. He noted that TIAA-CREF hadn't conducted any research into whether its activism resulted in increased returns to its mutual fund shareholders, but that it did consider similar research done by others. He said that TIAA-CREF was presently considering whether to take a role in social issues (such as environmental practices) of its companies. He noted that many TIAA-CREF shareholders wanted it to take a stand on social issues, and that TIAA-CREF had to balance this desire of some of its fund shareholders against the need to maximize returns for all fund shareholders. Mr. Wilcox observed that TIAA-CREF had a fund that invested only in socially conscious companies.

Proxy Disclosure Rules. Mr. Roiter noted that, in its proposing release for the proxy voting disclosure rules, the SEC recognized that mutual funds have been historically passive voters, either voting with management or disposing of the investment, and had also expressed a hope that mutual funds and other institutional investors could play a role in corporate governance. He said that this appeared not to have happened. Ms. Goodman said that she had observed no increase in mutual fund activism since the proxy disclosure rules became effective, but that she had seen an increased reliance on proxy voting firms and more detailed proxy voting policies. She noted that there was no evidence of increased returns for mutual funds that take a more activist approach. She said that this might change as hedge funds and private equity funds become more involved in proxy voting with short-term goals in mind, because mutual funds and other long-term investors may need to protect their long-term goals. The panel then debated whether mutual funds were long-term investors, and concluded that while some mutual funds considered themselves to be long-term investors, others did not; and that regardless of outlook, all mutual funds had to carefully consider short-term opportunities.

Index Funds. The panel then debated whether index funds, which do not have the same ability to dispose of investments as actively managed funds, should take a more activist role. Ms. Goodman said that she understood the SEC to hold this view, but that there was a free-rider problem that discouraged funds from devoting significant resources to proxy voting. She noted that no court has determined that managers of index funds have a fiduciary duty to engage in shareholder activism.

Board Independence. Mr. Wilcox referred to Prof. Bhagat's findings that board independence was negatively correlated to a company's performance. He asked whether this suggested that mutual funds should vote against increased board independence. Prof. Bhagat said that he recommended reducing a 90% independent board to about 60% - 70% independent, to obtain the benefits of additional well-informed inside directors, but said that it would be very hard to design a study to identify the optimal percentage of independent directors for a board. Ms. Goodman agreed that one could add inside directors to improve the information available to independent directors while still retaining a board that was majority independent. Mr. Roiter observed that this analysis was complicated by the dual roles of independent directors. He said that one role was to serve as watchdogs for shareholders and as agents of the government to monitor for compliance with U.S. laws. He observed that there was not necessarily any correlation between stock performance and this role, but that the role reflected a societal judgment that corporations should obey the law. He said that the other role was to assist and prod management to improve returns, and observed that Prof. Bhagat's study focused on this return improvement role.

Regulation FD. The panelists then discussed the impact of Regulation FD on institutional investors. They were in agreement that Regulation FD did not prevent institutional investors from talking to a company's management or directors, and that broad policies could be discussed without any sharing of nonpublic material information.

Executive Compensation. The panelists discussed executive compensation, and whether precatory votes on executive compensation might improve corporate governance. Ms. Goodman observed that even without precatory votes, boards considered shareholder reactions to executive compensation. Mr. Wilcox said that TIAA-CREF intended to study whether precatory votes, currently allowed only in the United Kingdom and Australia, correlated with improved performance. He said that TIAA-CREF increasingly focused on the details of option plans rather than on gross size, and that TIAA-CREF was in favor of additional disclosure of executive compensation arrangements.

Majority Vote Proposals. The panelists discussed the majority vote proposals expected this proxy season. Mr. Roiter observed that several of these proposals had already been defeated, but that all of these defeats had occurred at companies that required a director that didn't receiving majority support to tender his or her resignation for the board's consideration. Ms. Goodman said that shareholders appeared generally to favor majority voting for directors, but cautioned that there could be unintended consequences, such as incomplete elections or losing directors needed to fulfill NYSE or other board independence requirements. Mr. Wilcox said that TIAA-CREF favored majority voting for directors, and that it would vote in favor of such proposals, abstaining only in the case of companies that have adopted procedures requiring directors failing to receive a majority to tender their resignation.

Publicity. In response to a question, Mr. Wilcox said that while he did not think that mutual funds voted for the sake of publicity, the public embarrassment that a board may experience if shareholders oppose it may have a positive impact on board behavior. The panelists then discussed the degree to which mutual funds were willing to make exceptions to their proxy voting policies, concluding that in general mutual funds did not make exceptions. Mr. Roiter said that Fidelity considered input from portfolio managers when deciding how to vote, but that it was important to be aware of possible conflicts of interest.

Electronic Delivery. Finally, the panel discussed the SEC's electronic delivery proposal. Ms. Goodman noted that this provided communication benefits to both management and shareholders, but said that it was unclear how effective it would be with respect to street name holders. Mr. Wilcox said that he didn't consider it significant that dissident shareholders would be able to communicate better, since they still had to prove their case to other shareholders.

Panel 1-D: The Relationship between Funds and Subadvisers

Moderator: Christine C. Carsman, Vice President and Chief Regulatory Counsel, Affiliated Managers Group, Inc.

Speakers: Darrell N. Braman, Vice President and Associate General Counsel, T. Rowe Price Associates
Arthur J. Brown, Partner, Kirkpatrick & Lockhart Nicholson Graham LLP
Bernt von Ohlen, Senior Counsel, USAllianz Advisers, LLC

This workshop focused on the relationships between mutual funds and their subadvisers. As an introduction to the workshop, Ms. Carsman stated that 1 out of 7 funds employ subadvisers and that these subadvisory relationships raise complex issues for mutual fund complexes.

Hiring of Subadvisers. Ms. Carsman asked Mr. von Ohlen to share his experiences relating to the hiring of subadvisers. Mr. von Ohlen first admonished the audience to get the lawyers and the internal compliance department involved early in the selection process. He reported that, in his experience, the investment adviser usually only performs an on-site due diligence visit with the subadviser finalist. Mr. Braman reported that his firm did not always receive on-site visits in connection with being selected as a subadviser for a mutual fund. Mr. Brown then reminded the group that recent regulations present themselves at this stage in the process (e.g., Rule 38a-1), and that the interaction between the chief compliance officer of the mutual fund and the administration staff of the subadviser needs to be significant before the investment adviser presents the subadviser to the board of the mutual fund for approval. Mr. von Ohlen reported that boards are paying much more attention to the diligence process. He also reminded the group that the diligence team should keep in mind that they are laying a foundation for a long-term relationship. Mr. von Ohlen finally stated that the membership of the compliance team that may visit a subadviser may vary and that, in his experience, a typical team may include the chief compliance officer, the chief operating officer and one or more compliance staff members.

Mr. Braman then reported that his firm has a set of documents that they send out to mutual funds who have selected them as the finalist. He said that, in his experience, a potential subadviser will want to know, amongst other things, the mutual fund's distribution capabilities, the board's expectations for subadvisers, and whether there are any cash management expectations. In addition, the subadviser will want to see all of the policies and procedures of the mutual fund that are applicable to the subadviser. Mr. Braman then reported that as a general matter his firm is unwilling to provide data that is limited to one or more clients of the subadviser, employee information such as employee trading, and lists of clients who have hired or fired the subadviser. Following Mr. Braman, Mr. von Ohlen reported that his firm does not ask about hiring and firing, but that they do ask about regulatory reviews (deficiency letters, current exams, etc.). He said that what his firm is looking for is a sense of the information provided in the deficiency letters, and that his firm understands that it may not receive copies of the deficiency letters.

Mr. Braman then confirmed that his firm will share a general sense of deficiency comments if the comments relate to his firm's service as a subadviser but that they will not share the letter itself. With respect to chief compliance officer reports, Mr. Braman reported that the report that his firm sends to the boards of mutual funds for which it is the subadviser is the same report that it sends to the board of the mutual fund complex that it sponsors, just modified to remove information that is not applicable to the subadvisory relationship. Mr. Brown then added that subadvisers are at risk if the information that they are providing to various fund groups is not parallel. He also stated that there is an implicit sense of confidentiality with respect to information that an advisory organization is reporting to the board of the mutual fund complex that it sponsors, but that the sense of confidentiality is not present when an advisory organization is sharing the information with 9 or 10 boards, such as is the case with some organizations that provides subadvisory services to multiple mutual funds.

The panel next reported that they had never used or seen outside firms to conduct diligence on a subadviser, but that the diligence process was always undertaken with internal staff. They also discussed that hiring a subadviser that had never provided investment advice to a mutual fund is more risky and requires more work at the initial stages of the relationship.

<u>Contract Issues</u>. Mr. Braman said that his firm used to provide its own form of contract but that it now uses the mutual fund's form. Mr. von Ohlen agreed that, in his experience, the mutual fund's form is used. Mr. Braman then reported that additional issues in the contract include whether the subadviser is expected to provide pricing assistance, and if so how that assistance is documented, and also whether the subadviser is to vote proxies. With respect to proxy voting, Mr. Braman's experience is that the one thing a subadviser does not want to do is be obligated to vote proxies using the mutual fund's proxy voting policies. Mr. von Ohlen then remarked that subadvisers are an important source of pricing and that there is a trend that subadvisers are now looking to have all of these types of issues spelled out in the subadvisory agreement. He also stated that there is also a parallel trend to have a separate manual that deals with some of these issues. Mr. Braman reported that his firm looks to have fund compliance matters also dealt with in the subadvisory agreement. Mr. von Ohlen stated that his firm's contracts have a CCO cooperation paragraph in their subadvisory agreements. Mr. Brown commented that the standard of care in subadvisory agreements should mirror the standard of care in the advisory agreement. He also recognized the need for a standardized contract.

<u>The 15(c) Process</u>. Mr. von Ohlen said that the approval process with respect to subadvisory agreements should be no different than that for advisory agreements. Mr. Brown then remarked that smart regulation would have the board play a lesser role in the contract approval process with respect to subadvisers because the subadvisory relationship (other than such relationships that are with affiliated subadvisers) is a true third-party relationship. Mr. Braman then remarked that a plain reading of the <u>Gartenberg</u> decision would not require a profitability analysis with respect to subadvisers. He further remarked that counsel for mutual funds are sending lengthy questionnaires to subadvisers. Mr. Brown remarked that he has seen questionnaires get shorter because the compliance items have been moved to the 38a-1 annual review. Finally, Mr. von Ohlen remarked that the new disclosure rules have resulted in a guided

discussion by fund boards and that subadviser profitability information provided to boards varies greatly among subadvisers.

The Ongoing Relationship. With respect to the ongoing relationship with sub-advisers, the panel first focused on the amount and quality of contact between a board and subadvisers. Mr. von Ohlen remarked that his firm only has subadvisers present to the board on an as-needed basis and only telephonically, but that other fund complexes have subadvisers present to the board on a regular schedule. Ms. Carsman then remarked that, as far as she was aware, there was no real guidance for boards on this matter and that each board needs to determine what it is comfortable doing. Mr. Braman then remarked that as a subadviser, he likes to have board contact. Finally, Mr. Brown remarked that he is comfortable advising directors to only see subadvisers when there are issues, but that he has also seen boards invite subadvisers who are at either extreme in terms of performance to present to the board.

Reporting. Mr. von Ohlen said that his firm receives quarterly reports from subadvisers, which are then reported to the board by the chief compliance officer. Mr. Braman then reported that his firm used to have a form of board report, but that now his firm uses the clients' checklists. Mr. Brown then reported that boards usually only want exception reporting. He remarked that there is an issue for advisers with regard to monitoring of subadvisers. Specifically, Mr. Brown noted that advisers have a duty of supervision but that it is an open issue whether that duty is the same duty of supervision that an adviser has with respect to its employees.

Panel 1-E: Enforcement and Litigation Issues

Moderator: John H. Bluher, Executive Vice President and General Counsel, Janus Capital Group

Speakers:
Frances S. Cohen, Partner, Dechert LLP
Mark A. Kirsch, Partner, Clifford Chance
Daniel T. Steiner, Executive Vice President and General Counsel, ICI Mutual Insurance Company
Jason A. Tucker, Managing Director and Senior Litigation Counsel, Putnam Investments

Mr. Bluher noted that the primary purpose of the panel was to discuss the status of various private litigation facing the mutual fund industry in the wake of the numerous market timing, revenue sharing and other regulatory investigations, enforcement actions and settlements commencing in 2003. He noted that the ICI conference materials include a comprehensive memorandum summarizing the status of the various law suits and related legal issues.

Mr. Steiner categorized the pending private litigation into the following five areas: (i) market timing and late trading of mutual fund shares, (ii) fee-based litigation alleging that investment advisers and their affiliates charged excessive investment advisory and/or distribution fees, (iii) allegations of improper distribution practices, including revenue sharing, "shelf space" and directed brokerage arrangements, (iv) allegations that funds failed to properly fair value portfolio securities and calculate net asset values appropriately, and (v) allegations that investment advisers failed to ensure that funds participated in class action settlements with respect to securities held in their portfolios.

Maryland MDL. Mr. Steiner noted that, in 2004, numerous federal private actions relating to market timing and late trading, involving at least eighteen mutual fund families, was consolidated by the federal Judicial Panel on Multidistrict Litigation in a multidistrict proceeding assigned to the United States District Court for the District of Maryland (the "Maryland MDL"), under the supervision of federal District Judge J. Frederick Motz. He said that, generally, the Maryland MDL suits fall into one of the following categories: (i) class actions filed on behalf of mutual fund shareholders, (ii) derivative actions purportedly filed on behalf of mutual funds, (iii) class actions filed on behalf shareholders of public parent or holding companies of investment advisers, (iv) derivative actions purportedly filed on behalf of parent or holding companies of investment advisers and (v) class actions filed on behalf of participants in ERISA plans invested in mutual funds. He noted that the fair valuation suits referenced above have also been consolidated with the Maryland MDL.

Mr. Steiner noted that Judge Motz has taken a business-like and pragmatic approach in his supervision of the Maryland MDL. He said that Judge Motz has made clear that the cases would not result in large awards for plaintiffs in light of the substantial sums that have already been paid by defendants under the various regulatory settlements with the SEC. Mr. Steiner pointed out that Judge Motz is strongly encouraging settlement of these cases, having noted in a letter to counsel his view that "resolution of damages issues may be critical to a prompt and economic resolution of this litigation," and inviting the parties to "focus on the total amount of recoverable damages and the effect of any settlements or restitution agreements that may have been reached."

Mr. Steiner reported that, in omnibus rulings issued on August 25, 2005, Judge Motz dismissed many of the claims asserted by the class action plaintiffs in the Maryland MDL, but generally allowed claims under Section 36(b) of the Investment Company Act of 1940 (the "1940 Act") (and related claims under Section 48(a) of the 1940 Act) and claims under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (the "1934 Act") to survive, and dismissed all but the Section 36(b) claims in the derivative complaints. He said that defendants are now in the process of answering the surviving complaints (due in early April) and responding to discovery requests (which had been stayed pending the court's ruling on the motions to dismiss).

SEC Settlement Distribution Plans. Mr. Kirsch then discussed the status of the pending distribution of proceeds from the various market timing/late trading settlements with the SEC. He noted that the SEC entered into such settlements with more than 20 mutual fund advisers and their affiliates, pursuant to which over $2 billion in disgorgement and civil penalties has been deposited in "Fair Funds" for the benefit of mutual fund shareholders allegedly harmed by market timing/late trading. Mr. Kirsch noted that each of the settlement agreements with the SEC requires respondents to retain an "independent distribution consultant" ("IDC") to develop a plan of distribution which must be "acceptable" to the SEC staff and the independent directors of the particular mutual fund, and ultimately must be approved by order of the SEC under its Rules Regarding Fair Fund and Disgorgement Plans.

Mr. Kirsch noted that the SEC has extended the deadlines for IDCs to submit distribution plans multiple times, and thus far only 2% or so of the money in the Fair Funds has been distributed. He noted that the IDCs have, in consultation with the SEC staff, faced a number of complex economic, legal, tax and other issues in developing the distribution plans, due in part to the SEC's apparent position that amounts in the Fair Funds should be distributed directly to harmed shareholders, rather than to the mutual funds themselves. He said that the most complicated and time consuming aspect of the IDCs' work has involved developing and applying methodologies to assess harm to shareholders from market timing/late trading. Mr. Kirsch said that, after significant back and forth on this issue, the SEC has indicated that it will not require precise uniformity in the harm calculation methodologies used by the various IDCs.

Mr. Kirsch noted that, due in part to pressures imposed by the Governmental Accountability Office and others, the SEC is likely to require that a significant number of the IDCs submit their plans of distribution in late March 2006, after which the plans will be made available for public comment. He said that the SEC staff has proposed September 30, 2006 as a target date for distributions to commence.

Mr. Kirsch said that it is expected that amounts in the various Fair Funds will in most cases exceed the monetary harm to shareholders from market timing/late trading as estimated by the IDCs. He noted that the industry is interested in whether the plaintiffs' bar will comment on the IDC distribution plans and related methodologies, particularly in light of Judge Motz' indication that, if the SEC settlements provide full restitution to those who were harmed, the private plaintiffs will not be entitled to further recovery. Mr. Kirsch noted that at least one defendant in the market timing litigation has filed a motion to dismiss arguing that, because full restitution exists in the Fair Fund, plaintiffs lack standing to sue for additional damages due to a lack of subject matter jurisdiction. He said that the court has yet to rule on that motion.

Excessive Fee Litigation. Ms. Cohen then discussed the status of various excessive fee cases brought under Section 36(b) of the Investment Company Act of 1940 (the "1940 Act"). She noted that Section 36(b) allows for private rights of action, which courts have consistently analyzed under the standard set forth in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), i.e., that an investment adviser may be liable for a breach of fiduciary duty under Section 36(b) if it charged a fee "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." She noted that, while the Gartenberg standard is consistently used to evaluate excessive fee claims, the federal district courts have differed as to what plaintiffs must allege in order to sufficiently plead a claim under Section 36(b).

Ms. Cohen reported that the courts have generally allowed so-called "pure form" excessive fee cases to proceed under Section 36(b), in which plaintiffs allege that payments to the investment adviser or its affiliates are excessive for reasons such as failure to pass on economies of scale or charging fees to mutual funds that are higher than those charged to similar institutional accounts or comparable funds. She noted, however, that the courts have been largely divided as to whether Section 36(b) cases may be brought which allege that excessive fees have resulted from improper distribution practices, such as the use of directed brokerage, revenue sharing, improper soft dollar arrangements or wrongful approvals of Rule 12b-1 plans.

Ms. Cohen noted that the court in the Maryland MDL denied the defendants' motion to dismiss the plaintiffs' Section 36(b) claims. Although Judge Motz concluded that the plaintiffs could not assert Section 36(b) claims as a means generally to challenge late trading or market timing practices or to recover profits realized by the alleged wrongdoers, the court held that

Section 36(b) claims could be asserted "for excessive fees and expenses resulting from the defendants' scheme." Ms. Cohen noted that the court found support for allowing the Section 36(b) claims to proceed based on plaintiffs' allegations that advisory and distribution fees had been increased as a result of market timing/late trading (e.g., through additional asset flows to the funds) and that advisory fees resulting from "sticky assets" deposited by market timers and late traders in affiliated funds had not been earned by the adviser.

Ms. Cohen noted that various district court decisions regarding Section 36(b) are being reviewed on appeal, and that many in the industry expect that the appellate courts will clarify some of the confusion that has resulted from the various lower court decisions in the next twelve to eighteen months.

Ms. Cohen reported that a number of courts have recently addressed whether plaintiffs have standing to assert claims with respect to multiple funds in a particular fund family where the plaintiffs own shares in only a subset of the funds. She said that defendants have challenged plaintiffs' constitutional standing under Article III as well as statutory standing under Fed. R. Civ. P. 23.1 and Section 36(b) of the 1940 Act. She reported that the courts in these cases have overwhelmingly held that plaintiffs lack standing to sue on behalf of funds in which they do not own shares.

"Holders" Suits Preempted. Mr. Tucker then reported on a decision of the U.S. Supreme Court in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, No. 04-1371, 2006 U.S. LEXIS 2497 (March 21, 2006), which was handed down on the day of the panel. He reported that, in a unanimous decision, the Supreme Court held that Title I of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preempts state law securities class actions brought on behalf of "holders" of securities. Mr. Tucker noted that SLUSA provides that no covered class action based on state law and alleging a misrepresentation or omission of a material fact "in connection with the purchase or sale of a covered security" may be maintained in any state or federal court by any private party. He said that plaintiffs have argued in various cases that "holders" are distinguishable from "purchasers or sellers" for these purposes. He noted that the Second Circuit had determined in a lower court ruling in Dabit that SLUSA does not preempt securities actions brought on behalf of "holders" when the plaintiff and class definition is limited to those who held shares throughout the class period and expressly excludes anyone who purchased or sold shares throughout the class period. Mr. Tucker said that, in reversing the Second Circuit, the Supreme Court's decision in Dabit appears to stand for the proposition that the distinction between "holders" and "purchasers and sellers" is irrelevant for these purposes. He said that the case has important implications for various state law class action claims that have been brought on behalf of mutual fund shareholders.

Recent Remarks of Lori Richards. Mr. Bluher concluded by summarizing the key points of a speech given by Lori A. Richards, Director, Office of the Compliance, Inspections and Examinations ("OCIE"), at the Eighth Annual Investment Adviser Compliance Summit held in Washington, D.C. on February 27, 2006, regarding fiduciary duties of investment advisers and related conflicts of interest. He noted that Ms. Richards had identified the top 5 deficiencies OCIE has identified in recent inspections of U.S. registered investment advisers, as: (i) deficient disclosure (noting that approximately half of the deficiencies OCIE finds in this area relate to inaccurate, incomplete and even misleading information in Forms ADV, and the other half include problematic disclosure of business practices and fees charged to clients), (ii) deficiencies in portfolio management (including inadequate controls to ensure that investments for clients are consistent with their mandates, risk tolerances and goals), (iii) deficiencies with respect to personal trading by employees of investment advisers (including a lack of controls, a lack of required codes of ethics, and failure to implement stated procedures and monitor personal trading), (iv) deficiencies in performance calculations (including overstated performance results, comparing results to improper indices, failure to disclose material information about how performance is calculated, using prohibited testimonials, and advertising past results in a misleading manner), and (v) deficiencies in brokerage arrangements and execution (including poor or no controls to ensure that the adviser obtains "best execution," and secretly using clients' money to pay for client referrals and for other goods and services that benefit the adviser).

General Session : Breaking Down the Myths about the Mutual Fund Industry

Moderator: Brian Reid, Chief Economist, Investment Company Institute

Speakers: Tim Armour, Managing Director, Morningstar, Inc.
Avi Nachmany, Executive Vice President and Director of Research, Strategic Insight
Erik Sirri, Professor of Finance, Walter H. Carpenter Chair, Babson College
Laura T. Starks, Charles E. and Sarah H. Seay Regents Chair In Finance, University of Texas at Austin

The panel addressed a number of prevailing "myths" regarding the mutual fund industry.

Myth #1: "*The Mutual Fund Industry Is in Decline*." Mr. Reid pointed to several statistics (including continued growth in overall assets under management and the percentage of U.S. households that own funds) as evidence of the ongoing strength of the mutual fund industry. Mr. Armour noted his "cautious optimism" about the industry. He stated that while the industry has made modest reductions to total fund expenses over time, this is an area in which the industry will need to make more progress in the future. Mr. Nachmany noted that while the consensus outlook for mutual funds was pessimistic just three years ago, the current outlook is much improved. The factors he cited in support of this include the stability of assets under management, investors making better choices, the open architecture of fund distribution arrangements, and lower portfolio manager turnover. Mr. Armour stated that alternatives to mutual funds, including exchange traded funds, separately managed accounts, and hedge funds, are all growing robustly, and that many mutual fund managers are attempting to diversify into these areas, but that for a variety of reasons these alternative products will never be a serious threat to mutual funds. Mr. Nachmany said that ETFs are popular mostly with institutional investors, that separately managed accounts have severe operational limitations, and that hedge funds are restricted only to certain sophisticated investors. As such, he believes that none of these alternative products will have a significant impact on the mutual fund industry.

Myth #2: "*There is No Market Discipline in the Mutual Fund Industry*." Ms. Starks stated that the mutual fund industry is highly competitive. She pointed to the increasing press coverage of the industry, which provides investors with more overall information.
Mr. Nachmany noted the open architecture of mutual fund distribution arrangements, which also provides competitive discipline in the industry. Mr. Sirri stated that the industry needs to address the basic saving needs of individuals (e.g., for college tuition), and Mr. Armour predicted that

additional innovative retirement and savings products will be coming out in the near future. Mr. Reid noted that the marketplace has forced firms to focus on performance, costs and reduced portfolio turnover. Ms. Starks stated that while performance is the most important factor for fund flows, costs play an important role as well. Mr. Sirri noted that performance is the primary factor in a prospective investor's decision to open an account, but it may not be as important with respect to the retention of that account over time. Mr. Nachmany stated that good service to, and effective communications with, investors is far more important to account retention. Similarly Ms. Starks noted that advertising does not influence inflows, but may help to prevent outflows.

Myth #3: "*Small Fund Firms Are Doomed*." Mr. Reid noted that much innovation in the mutual fund industry has come from small fund companies. Mr. Nachmany stated that in the current regulatory environment, it has become more difficult for small firms to be successful in the industry. He noted, however, that small firms with good performance track records are succeeding and will continue to succeed in the future, and that the open architecture of distribution arrangements has helped high performing small firms. Ms. Starks noted that the vibrancy of the subadvisory market has been good for small firms. Mr. Nachmany stated that variable annuity platforms have transitioned almost exclusively to subadvisory arrangements. Mr. Armour stated that financial intermediaries are constantly looking for "hot" new managers, which should also sustain the prospects of small firms.

Myth #4: "*The Mutual Fund Industry is Failing to Deliver Economies of Scale*." Mr. Sirri noted that over the past fifteen years, there has been almost a ten-fold increase in assets under management in the industry, but expense ratios have only decreased by a few basis points, and asked whether this reflects a failure on the part of the industry to deliver scale economies. Mr. Sirri noted, however, that services have become more complex and richer, and that investor demand for additional services explains the absence of significant economies of scale. He also noted that average account size is a major factor in achieving economies of scale. Mr. Nachmany noted that management companies are considering increasing minimum account sizes in order to reduce costs. He compared the mutual fund marketplace in the U.S. with that in Europe, where average account sizes are 50% of those in the U.S. and expense ratios of funds are approximately double those in the U.S. Mr. Armour noted that multiple share classes and esoteric investment strategies also result in higher costs. Mr. Sirri stated that while mutual funds have traditionally been seen as a home for the small investor, small account sizes are driving up costs, and it is unclear whether funds will be able to continue to support small accounts in the future.

Myth #5: "*Fund Boards Are Ineffective*." Mr. Sirri noted that fund boards in the past three years have been spending increasing time on regulatory and compliance matters, and less on fund performance and general business issues. Mr. Armour noted that Morningstar's advisory services for Section 15(c) contract reviews have grown dramatically, indicating that independent directors are serious about wanting to do the right thing. He stated that boards are faced with overwhelming amounts of information, akin to "drinking from a fire hose," and that all boards are looking for more streamlined data and analysis. Ms. Starks stated that independent directors serve as "watchdogs," and their mere existence changes the behavior of management companies, similar to the impact of a traffic policeman on a highway. Mr. Sirri noted that mutual fund shareholders do not understand what boards do. Mr. Nachmany noted that boards are asking important business and strategic questions of fund managers.

Myth #6: "*Financial Intermediaries Provide No Value*." Mr. Reid noted that 85% of mutual fund sales are through intermediaries, which demonstrates that consumers place value on the services provided by intermediaries. Mr. Sirri noted that in the U.S., individuals are primarily responsible for their own retirements, and that they need intermediaries with expertise to help them navigate through complicated financial markets and product choices.

Panel 2-A: Responsibilities of Fund Directors

Moderator: Craig S. Tyle, General Counsel, Franklin Resources

Speakers: Stuart Coleman, Partner, Stroock & Stroock & Lavan LLP
Susan Nash, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission
Paul Roye, Senior Vice President, Fund Business Management Group, Capital Research & Management Company
Robert W. Uek, Independent Trustee, MFS Funds

Impact of Management Contract Approval Disclosure. Mr. Tyle began by asking the panelists how the recent adoption of management contract approval disclosure rules had affected the contract approval process. Mr. Coleman said that he had observed significant practical changes, such as longer meetings, more preparation with outside counsel, more meeting materials, meeting materials redesigned to match the logic and structure of the disclosure requirements, and more information regarding institutional account pricing. He said that boards now spend more time discussing profitability. He observed that profitability analysis was more complicated than simply analyzing asset growth, and that profitability was affected by the channels through which asset growth was achieved. He noted that profitability could increase without the introduction of economies of scale.

Mr. Uek said that the MFS Funds' board had found that financial expertise was of increasing importance and that, as the volume of contract approval information increased, the review process itself became more important. Ms. Nash said that the SEC staff had seen a wide range of fund disclosure of management contract approval deliberations, ranging from unhelpful, conclusory statements to very detailed analyses. She said that in general, disclosure of profitability analysis tended to be too conclusory and brief, but noted that this may reflect a legitimate effort to protect confidential information. She said that she was aware that boards were increasingly making use of consultants in the contract approval process.

The panelists then considered a hypothetical fund that was small but growing and that had below average fees and good performance. Mr. Coleman said that the fund board, in considering whether to approve the continuation of the fund's management contract, needed to make a business judgment about the fees based on the Gartenberg standards. He said that the board would need lots of other facts, such as (i) where the fund is in its life cycle (if young, the adviser may be entitled to fees to reimburse it for research and development expenses and other entrepreneurial risk), (ii) whether there is actual profit and what the adviser intends to do with that profit (such as invest in shareholder services), and (iii) what was the board's previous anticipation of profitability.

Mr. Roye then commented generally on Sections 15(c) and 36(b) of the Investment Company Act, noting that they were adopted in 1970 at a time when it was thought that the market could not discipline investment company fees. He noted that perhaps this assumption is no longer correct, pointing out that in 1970 there were 350 open-end funds (versus approximately 10,000 now), that in 1970 funds couldn't advertise their performance (now they can), that in 1970 funds were generally sold directly (now intermediaries commonly provide access to funds) and in 1970 the mutual fund industry was a low-profile industry (now there is active press coverage of the industry). He also observed that, in the absence of these provisions of the Investment Company Act, boards would likely still have to consider management contracts to fulfill their fiduciary obligations under state law. He said that he regarded the private right of action provided by Section 36(b) as being a costly mechanism that provided no benefit.

Mr. Uek said that he regarded fund-by-fund review of fees and performance as a healthy exercise, commenting that it resulted in expense caps, breakpoints, fee waivers and other benefits to funds that would not necessarily otherwise exist. He said that regardless of the market's ability to discipline fees, "mutual funds are sold, not bought," and that there was still an important role for fund boards to play. Mr. Roye commented that market discipline could be inferred from the fact that there were huge inflows of capital to low-cost funds.

Ms. Nash said that it was not clear to what extent the market was competitive, and that many investors seemed unaware of fund fees. She noted that fund fees could also vary over time, and that it was not without cost for an investor to exit a fund if those fees increased. She said that she viewed private rights of action under Section 36(b) as a "backstop" on the SEC's limited resources.

Redemption Fees and Fair Valuation. Mr. Tyle asked the panel for views on redemption fees. Mr. Roye reviewed relevant factors for the board to consider, such as market timing disclosure, compliance policies addressing market timing, Rule 22c-2, and whether the fund in question was experiencing nuisance timers or arbitrage timers. Mr. Uek said that his board received regular reports from the adviser assessing market timing matters, and that his board considered it in connection with fair valuation. Ms. Nash characterized this as a "good board approach." She said that boards could not discharge their duties under Rule 38a-1 without looking at the implementation of market timing policies, including at the omnibus account level.

Mr. Tyle asked the panelists to what degree a board could rely on the adviser for fair valuation. Mr. Coleman observed that the SEC had indicated that the broader and deeper a fair valuation policy, the greater the acceptable reliance on an adviser for implementation. Ms. Nash agreed that day-to-day valuation matters could be delegated, "absent something extremely problematic." She said that the board needed to receive regular reports in order to exercise appropriate oversight. She also said that she expected that fair valuation guidance would be presented to the Commissioners for their consideration by mid-2006.

Service Provider Fees. The panelists then discussed board responsibilities for administrative fees. Mr. Coleman said that in the case of an administrator affiliated with the adviser, it would be prudent for the board to consider administrative fees as part of the Section 15(c) process, but that in the case of an unaffiliated administrator, the board could review fees under the business judgment rule. Mr. Uek said that his board put a lot of effort into analysis of the fees paid to the MFS Funds' administrator, which is affiliated with the adviser. He said that the board sometimes retains consultants to review allocation methodologies.

Chief Compliance Officers. Mr. Tyle then asked the panelists what a fund board should do upon receipt of the fund's annual CCO report. Mr. Roye noted that Rule 38a-1 doesn't say that the board must make any annual finding. He then observed that the CCO should be viewed as a tool to help boards, and that relatively routine matters, such as transactions under Rule 17a-7 and similar rules, could be approved by the CCO rather than the board. He said that this would enable boards to consider more significant matters. Ms. Nash commented that CCOs should already help boards bear this type of burden by reviewing reports in detail and summarizing the reports for the board. She said that she was aware that boards seemed overburdened, and that the staff may consider ways to enable the board to focus more on conflicts of interest. Mr. Uek said that another approach to managing the increasing board workload was to allocate various matters to board committees, and to only consider the most important matters as a full board. He also said that that he felt more comfortable relying on a fund CCO that was not also the adviser's CCO than he would on a CCO that also served the adviser. Mr. Roye then said that it was important not to restrict a fund CCO's ability to also serve as an adviser CCO, noting that dual service could permit a CCO to obtain more information from the adviser.

Mr. Coleman said that, in principle, CCO compensation should be designed to neither inhibit performance nor to encourage turning a blind eye to compliance issues. He said that a reasonable benchmark might be the compensation paid to internal audit personnel, as well as that paid to other people within the organization of similar status to the CCO. Mr. Tyle observed that including adviser equity as a component of CCO pay (for a person serving as CCO to both funds and an adviser) should be acceptable on principle. He said that a strong compliance program should benefit the adviser and be reflected to some degree in its stock performance.

Soft Dollars and Best Execution. The panel then discussed the board's review of soft dollars and best execution. Mr. Coleman said that the board should evaluate the soft dollar budget, the ratio of soft dollars to hard dollars, and the purposes of the payments and benefits received by both the funds and the shareholders. Ms. Nash agreed with this statement, and said that the SEC staff was considering providing guidance in this area.

Distribution Arrangements. The panel then discussed distribution plans and fees. Mr. Tyle noted that written guidance for boards in this area did not contemplate the current environment, in which intermediaries typically collected distribution fees. Mr. Coleman agreed that earlier guidance in this area was of decreasing relevance, although boards still needed to consider it. He said that the fundamental analysis for a board was whether the distribution plans benefit the funds and shareholders being charged. He commented that the industry now had fairly standard fee structures for intermediary compensation.

The panel then discussed other distribution arrangements. Mr. Uek said that he did not believe that he was responsible for such matters as suitability and breakpoint application, but that he inquired about it from time to time. Ms. Nash agreed that these matters were the responsibility of broker-dealers, but that fund boards could not ignore it. She said that if a breakpoint structure was particularly complicated, or poorly disclosed, the board should look at it carefully. She also said that a board must consider these matters when it considers its funds' principal underwriter's compliance program. Mr. Roye agreed that although there was no affirmative legal obligation on the boards in this area, boards did need to monitor the principal underwriter.

Mr. Tyle observed that some recent regulatory settlements required fund boards to approve revenue sharing arrangements. He noted that disclosure in this area had recently become more detailed. Mr. Coleman said that boards should be informed of revenue sharing payments made from an adviser's profits as part of the Section 15(c) review. He noted that revenue sharing arrangements are often initially disclosed to boards in general, unquantified terms, and that boards should review actual expenditures as a follow-up matter. Ms. Nash said that revenue sharing payments were also relevant to distribution plan approvals, because boards needed to know what other distribution-related payments were being made.

Board Governance. Mr. Tyle observed that, notwithstanding the ongoing litigation, many funds have adopted independent chair requirements. Mr. Uek said that the MFS Funds have an independent chair, and that the chairman is a long-serving board member with substantial knowledge about the MFS Funds and MFS. He said that control of the board's agenda is important because it gives the board greater control over how to spend its "discretionary" time, which enables the board to focus its attention on significant projects of its choosing. He noted that an independent chair can also improve the efficiency of meetings, because an independent chair can terminate discussion on an issue without seeming biased or high-handed at times when an interested chair might.

Mr. Coleman said that the board evaluation process had yielded results ranging from a director deciding to step down to the directors deciding to hold a "boot camp" to study various matters. Mr. Roye agreed that the evaluation process could be helpful to directors who only attend meetings sporadically, enabling them to realize that they are not able to devote sufficient time to carry out their responsibilities. Mr. Coleman said that, in his experience, the board evaluation process seemed to improve board collegiality. The panelists then discussed whether recent increases in director workload had made it harder to recruit qualified independent directors to boards. It was their consensus that boards now put more effort into identifying candidates with skill sets complementary to those of the existing directors, but that once candidates were identified, recruitment was not any harder than before.

Use of Consultants. The panel then commented on the board's use of consultants, noting a recent trend to use more consultants. Messrs. Coleman and Uek said that consultants were most likely to be used in connection with Section 15(c) reviews and best execution matters. Mr. Coleman said that if a board hires a qualified consultant and gives that person adequate guidance, the board can rely on the consultant's findings of information. Ms. Nash pointed out that even so, the board is still responsible for exercising its judgment based on information provided by the consultant.

Panel 3-A: The Relationship between Independent Directors and Outside Counsel

Moderator: Frank J. Nasta, Managing Director and General Counsel, J. & W. Seligman

Speakers: Kenneth J. Berman, Partner, Debevoise & Plimpton LLP
John A. MacKinnon, Partner, Sidley Austin LLP
Peter Meenan, Independent Director/Trustee, MainStay Funds/Vantagepoint Funds
Patricia L. Sawyer, Independent Trustee, Diversified Investors Funds Group

Mr. MacKinnon began the discussion by reviewing the historical evolution of the independent counsel rule. He noted that in the brokerage cases of the early 1970's the courts had been critical of independent directors for not seeking independent legal advice or for relying on counsel who also represented the investment adviser. Similarly, the courts in the fee cases of the early 1980's identified the role of independent legal counsel as an important element of an independent deliberative process relating to advisory fees. Then in the mid-1990's, a series of best practices reports, beginning with one from a task force appointed by the ICI to comment on board practices, urged the retention of independent legal counsel to the independent directors. The only reservation expressed in these reports was a recognition that the costs associated with the engagement of independent legal counsel might present a burden for very small fund groups. Mr. MacKinnon quoted statistics from a recent survey showing that 51% of independent directors currently have independent legal counsel separate from the adviser and the funds, another 31% have counsel that acts only for the funds and the independent directors and 15% do not have independent counsel.

Mr. Berman then reviewed the operation of the independent counsel rule, calling attention to the SEC's adopting release which provides useful guidance and flexibility for dealing with certain special situations, such as the case of subadvisers.

The panelists responded to the question of whether any particular model for structuring the counsel relationship was preferable. There was a consensus that both models had worked well in practice and were acceptable to the SEC. Several panelists noted that having the independent trustees use counsel that also served as counsel to the funds (but not the adviser) made for somewhat simpler communications, although one panelist said that there was a risk that counsel for the funds, who typically is heavily involved in the preparation of materials for the board's consideration, might have somewhat more difficulty in taking an entirely fresh and dispassionate perspective when it came to advising the independent directors. The panelists concluded that the choice of model depended in large part on the preferences of the independent directors for how they wished to use counsel and involve counsel in discussions with the investment adviser.

The panelists discussed whether independent legal counsel should be subjected to an annual diligence review. It was suggested that the independent directors should be generally aware of the other kinds of clients served by the independent legal counsel individually and by his or her firm. For example, while it is commonplace for law firms to represent many different participants in the mutual fund industry, the independent directors might wish to be aware if their counsel otherwise represented only investment advisers. In view of the potential cost of changing counsel, the panelists commented that there was great incentive to address any issues in existing counsel relationships before reaching the point where it became necessary to consider changing counsel. One panelist suggested that annual board self-assessment process also provided a good forum for reviewing the services of independent legal counsel.

The panel responded to the question of whether it would be appropriate for counsel to the independent directors to go beyond providing simply legal advice and to begin to function as a board consultant. It was noted that the increased regulatory burdens on mutual funds directors had led boards to become increasingly dependent on their independent counsel, and that it was important that counsel continue to focus on explaining alternative courses of action and their respective pros and cons, rather than advocating his or her own view as to the appropriate course of action. Likewise, the panelists agreed that a board member with legal training and experience should make his or her expertise available to the board, but not usurp the role of counsel.

The panel also responded to the question of whether there is a conflict between the independent directors and the shareholders when counsel who is also fund counsel advises on matters having to do with compensation, indemnification and insurance for independent directors. The panelists agreed that these matters placed the directors themselves in conflict with the shareholders at some level, but that it should nonetheless be appropriate for counsel to assist in helping the board to gather information and otherwise support the board's own decision-making process.

The panelists discussed how boards dealt with inevitable issues of succession when a lead lawyer approaches retirement. They agreed that this was typically dealt with in the broader context of the total relationship with the lawyer's firm, including consideration of the quality of back-up support within the firm, but that because the relationship is often a very personal one, an imminent retirement of a lead lawyer sometimes results in a reassessment of the engagement. However, given the importance of communication and trust in fostering an effective relationship with independent legal counsel and the difficulties in changing counsel noted earlier, the panelists urged that boards should focus on managing and enhancing this relationship in a way that best serves the changing needs of the board and the changing demands of the regulatory environment.