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The following lawyers contributed to the preparation of this report:

Alyssa Albertelli
Robert J. Borzone, Jr.
Rajib Chanda
Bryan Chegwidden
Gregory C. Davis
Timothy W. Diggins
Michael G. Doherty
Leigh R. Fraser
John W. Gerstmayr
Thomas R. Hiller
Daniel O. Hirsch
Susan A. Johnston
Philip S. Khinda
John M. Loder
Richard Marshall
Brian D. McCabe
Alan G. Priest
Gregory D. Sheehan
David C. Sullivan
James E. Thomas
Joel A. Wattenbarger

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President's Address

Speaker: Paul Schott Stevens, President, Investment Company Institute

Mr. Stevens began by discussing the impacts of the globalization of financial markets and of technology on the investment management industry. He noted the explosive growth of world financial markets in recent years, and said that economic studies have documented erosion in the United States' status as the center of world financial markets. As an example, he noted that U.S. exchanges have a declining share of new listings of securities. He cited the requirements of the Sarbanes-Oxley Act and the threat of class action lawsuits as two potential causes of the decline in U.S. public offerings.

Mr. Stevens said that the investment management industry is at a crossroads, and needs to determine how to keep mutual funds safe for investors while remaining globally competitive. He stated that aggressive enforcement by the Securities and Exchange Commission (the "SEC") is critical to investors' confidence and the integrity of U.S. markets. However, he recommended that the SEC systematically reconsider its organization, structure and approach to regulation, and in particular, pursue a more principled approach that considers the costs and benefits of potential regulatory initiatives. He cited two recent initiatives where he did not believe the benefits outweighed the costs:

- The recently proposed changes to New York Stock Exchange ("NYSE") Rule 452, which would treat uncontested director elections as non-routine, so that brokers could not vote clients' shares in such elections without receiving voting instructions from their clients. Mr. Stevens said that Investment Company Institute ("ICI") research indicated that the cost of soliciting proxies for investment companies in an uncontested election would increase from an average cost of $1.65 per shareholder to an average cost of $3.68 per shareholder, adding between one and five basis points to each fund's expense ratio. The ICI has asked the NYSE to reconsider this rule's application to mutual funds, which tend to have a greater percentage of individual investors than other issuers.

- The fund governance rules originally proposed by the SEC in 2004. He said that the interests of fund shareholders are well served by the actions of two fiduciaries – independent directors and investment advisers – and that fund governance should be entrusted to fund directors in the exercise of their discretion, because a single SEC-mandated structure may not be appropriate for every fund.

Mr. Stevens concluded by discussing two areas that merit future rulemaking by the SEC. First, he stated that the SEC should critically review the role of mutual fund directors and the burdens imposed on them by regulations and exemptive orders, and noted that Andrew J. Donohue, the Director of the SEC's Division of Investment Management, has already started this review. Second, he recommended that the SEC consider new approaches to the disclosure provided to mutual fund investors, including adopting a "quick-start guide," or fund summary, that would clearly and concisely highlight the key information that investors need, with additional information being available on the Internet, or in paper upon request.

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Keynote Address

Speaker: Andrew J. Donohue, Director, Division of Investment Management, U. S. Securities and Exchange Commission

Mr. Donohue said that one of the reasons the mutual fund industry has been so successful since 1940 is that it is supported by a regulatory regime that protects investors. The role of the SEC is to make sure that the interests of investors are paramount to those of fund management.

Mr. Donohue discussed four areas the SEC needs to work on going forward:

Modernizing Rules for the 21st Century. Mr. Donohue said that the SEC should consider modernizing certain regulations so that they are more effective in today's markets. In particular, he cited the investment adviser and investment company books and records requirements, which are inadequate for the needs of SEC examiners and the industry. He said that he expects a significant overhaul of these requirements, after a comprehensive review, focusing on possible technological alternatives. Members of the SEC staff (the "Staff") have already started this review. Mr. Donohue said that the Staff's review will not be rushed and he expects it will continue throughout the year.

International Coordination. Noting the increasing globalization of securities markets, Mr. Donohue said that he has been meeting with non-U.S. regulators to discuss various regulatory regimes, and noted that the regimes of many countries were developed after the U.S. regime and adopt a more modern approach. He said that if the U.S. were adopting a regulatory regime today, he would not expect it to regulate the financial markets through four different main statutes, as well as separate statutes for banks, insurance companies and other parts of the financial sector. He also urged the fund industry to look overseas for investor-oriented practices that could be imported to the United States.

Remembering the Basics. Mr. Donohue said that fund regulators and the fund industry need to remember the basics of putting the interests of investors first. He expressed concern over a case recently settled by the SEC in which three closed-end funds paid 98 distributions out of net capital over a four-year period without providing the written statements identifying the source of the payment required by Rule 19a-1 under the Investment Company Act of 1940, as amended (the "1940 Act"). He said that basic regulatory requirements like this one should be "hard-baked into the DNA" of any fund management firm. He also said that he is committed to reviewing the role of fund directors, to ensure that they have enough time to perform the important role of overseeing conflicts. He is reaching out to fund directors to hear from them what the SEC can do to increase their effectiveness. Finally, he said that he understood the role that technology can play as a tool for investors, and discussed in particular the use of interactive data, such as XBRL, which facilitates the analysis of fund information. He also stated that the Staff is undertaking to recommend to the SEC a short form, streamlined disclosure document for mutual fund investors, with additional information available on the Internet or in paper upon request.

"Confronting Our Fears". Mr. Donohue concluded his remarks by discussing issues about which he said he is currently worried. He noted that these issues are matters of emerging concern, and not all of them will necessarily result in additional regulation. First, he said that consideration of Rule 12b-1 under the 1940 Act is a high priority for the Division of Investment

Management this year, and that the Division will address this Rule during Mr. Donohue's tenure. He noted that the Rule was adopted at a time when mutual funds had suffered significant net redemptions and the SEC was worried about the survival of certain funds. He stated that the primary use of Rule 12b-1 fees has since shifted from marketing and advertising, as originally envisioned, to servicing or as an apparent substitute for a sales load. Mr. Donohue also said he is worried about the proliferation of yield-based investment products, and that there needs to be clear disclosure to investors as to how the yield is generated and the potential risks. Finally, he said that he is worried about the use of derivatives and other sophisticated financial instruments by mutual funds, and said that legal, compliance and accounting personnel should be sure they understand any derivatives arrangement before an investment is made.

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Keynote Address

Speaker: Elisse B. Walter, Senior Executive Vice President, Regulatory Policy & Programs, NASD

Ms. Walters began by describing the U.S. financial services industry as a phenomenal success story and the U.S. regulatory system as the envy of the world, but cautioned that the industry and regulators need to adapt to the fundamental economic, demographic and technological changes affecting the industry and society to avoid "mediocrity or worse." She said that the industry and regulators need to be proactive in protecting and serving investors in light of these changes.

Regulatory Consolidation. Ms. Walters believes that strong self-regulatory bodies play an invaluable role in regulating U.S. markets by bringing industry expertise directly to bear in tackling the issues faced by investors and firms. In her view, the consolidation of NASD and NYSE member regulation will streamline the oversight of securities firms in the United States and improve the way regulation is conducted while at the same time better protecting investors. Ms. Walters said that the benefits of this consolidation include bringing together all of NASD's and NYSE's examination and enforcement functions, as well as arbitration and risk assessment. She noted that the consolidation will result in a single set of rules adapted to firms of all sizes and business models, one set of examiners and one enforcement staff.

Changing Needs of Investors. Ms. Walters next argued that industry and regulators need to proactively serve investors by appreciating and responding to their changing needs. She cited troubling statistics relating to personal savings rates in the U.S. (especially for retirement), consumer debt and the demographics of the U.S. population. She noted an increasing number of "unseasoned investors," such as new immigrants and older women. Ms. Walters emphasized that the financial services industry has an important role in helping Americans do a better job of managing their money by helping investors to "set realistic financial goals, learn the principles of sound investing, and understand the products that are offered to them." She described NASD's role in this effort, citing, as an example, amendments to advertising rules that permit brokers to offer their customers investment analysis tools.

Ms. Walters also described NASD's focus on investor education and tools offered on the NASD website for this purpose. She noted the establishment of the NASD Investor Education Foundation in 2003, the largest foundation in the United States dedicated to investor education, and described recent grants by the foundation to study investor behavior. Ms. Walters said that one study has shown that a principal reason many employees do not take full advantage of employer-sponsored retirement plans is inertia. This suggests that the power of inertia can be harnessed to augment retirement savings simply by moving from an "opt-in" retirement plan to an "opt-out" retirement plan (*i.e.*, one that features certain automatic features, including enrollment, unless one opts out).

Globalization. Ms. Walters noted that globalization places pressures upon the U.S. regulatory system because we are "in an era in which the preeminence of the U.S. capital markets is not a matter of divine right." She emphasized, however, that NASD should not and would not use globalization as an excuse for weakening investor protection or compromising market integrity in the United States. The NASD will not engage in a "race to the bottom of the least regulation." By the same token, however, the regulatory system should not push capital formation outside the U.S. by imposing an unjustified burden on industry. Because of these competing concerns, she said that NASD will analyze burdens and benefits with respect to any new rulemaking, and will also analyze existing rules to identify any that have become obsolete. Furthermore, she said that NASD is revisiting recently enacted rules to analyze the impact of such rules in practice. While a cost-benefit analysis is not required by law, Ms. Walters said that it is necessary for effective regulation in the age of globalization.

Disclosure. Ms. Walters believes investors need a more effective and streamlined disclosure regime for the entire universe of investment products. She noted the SEC's leadership in this area, including the fund profile and XBRL initiatives.

Ms. Walters said that NASD "enthusiastically" supports the SEC's point-of-sale disclosure proposal. She reported on a task force of industry experts convened by NASD to consider point of sale disclosure, and noted two major differences from the SEC's proposal. First, she said, the task force believed that point of sale disclosure should include a fund snapshot (including investment risks and strategies), as well as the information about fees, expenses and conflicts proposed by the SEC. Second, the task force recommended that this point of sale disclosure be available to investors through the internet if they prefer.

Ms. Walters noted that disclosure initiatives cannot be limited to the mutual fund industry, and in particular noted the varying levels and types of information provided by sponsors of 401(k) and other employee retirement plans. She recommended that the short-form document to be proposed by the SEC also be required to be provided to investors in the employee plan market. Ms. Walters suggested that similar short-form documents may also be appropriate for other pooled investment vehicles, such as exchange-traded funds ("ETFs"), commodity pools and insurance products.

General Session: Innovations in the Fund Industry: Competitive Challenges

Moderator: Thomas P. Lemke, Moderator, Senior Vice President and General Counsel, Legg Mason Funds Management, Inc.

Speakers: Darlene DeRemer, Partner, Grail Partners, LLC
Joanne Medero, Global Head of Government Relations, Barclays Global Investors, N.A.
Paul David Schaeffer, Managing Director, Strategy & Innovation, SEI

Ms. DeRemer began by noting that the asset management industry continues to be highly profitable, with scale and technology helping to maintain robust profit margins. She forecast that industry assets will swell to approximately $35 trillion by 2010, with individual retirement account ("IRA") and defined contribution assets being the fastest growing segment, and that assets in ETFs will approach $2 trillion by 2011.

She then noted that the principal driving forces for the industry are strong, consistent investment performance, retention of the best talent, the growing importance of intermediaries, the changing composition of asset manager capitalizations (due to, amongst other things, IPOs and activity by private equity firms), the increased importance of open architecture, platform-based distribution and gatekeepers, changing demographics and the growth of alternative "packages" and investment strategies. She argued that the future for conglomerate asset management firms is not as promising as that of pure play asset managers due to the clarity of the latter's business purpose, more cohesive culture and ability to use equity to attract and retain talent.

Ms. DeRemer noted that 2006 had been a banner year for mergers and acquisitions activity in the industry and that 2007 is shaping up to be a strong year as well.

Mr. Schaeffer then described three forces which, in his view, are disrupting and changing the money management industry: public policy, technology and convergence. He believes that the industry is entering a more active and radical policy phase, that technology has moved beyond playing a role in infrastructure to become a critical way for firms to interact with clients and deliver products, and that industry participants need to stop thinking of the industry in terms of product "silos" and to think of it as a unified asset management business, with benchmarks becoming less important than outcomes.

During a Q&A period, the panelists considered whether ETFs will eventually supplant mutual funds. Mr. Schaeffer believes ETFs will continue to be important building blocks for clients. He predicted ETF growth but believes that mutual funds will continue to play an important role as well. Ms. Medero argued that the growth of ETFs is a positive development for the fund industry, in that it is pushing more retail investors into commingled funds of all types, including traditional mutual funds. She said that for institutional investors ETFs are another tool in the investor's toolbox, and that the real threat that ETFs pose is to derivative products. Ms. DeRemer said she believes ETFs will be complementary to traditional funds and not destructive of their role in the marketplace. Mr. Schaeffer said that ETFs could spark mutual fund growth, primarily through the introduction of funds-of-funds investing in ETFs.

The panelists then turned their attention to hedge funds. Mr. Schaeffer said that he believes the outcome-oriented nature of hedge fund strategies will trickle down to other products and become imbedded in outcome-oriented solutions. Ms. Medero said that the real question posed by the growth of hedge funds and the investment techniques used by them is whether a manager will be paid for alpha or for beta.

The panelists each gave a prediction for the industry. Mr. Schaeffer said he believed that Google will become an industry competitor. Ms. Medero said that she believed the industry will develop a product to address the risk of increased life expectancy, and that it will not be insurance-related but will likely use derivatives. Ms. DeRemer stressed the increasing globalization of the industry. Mr. Lemke predicted the continued use of soft dollars, which are, in his view, good for markets and investors and imbedded in the industry.

Ms. Medero then said that innovation in the industry is driven by investor demand for exposure to specific asset classes, markets or strategies, for structures that are eligible for investment by certain categories of investors and for lower investment expenses (or higher returns for higher fees). She also noted that both U.S. and non-U.S. investors are seeking exposure to a variety of asset classes in both U.S. and non-U.S. markets and that the marketplace is global in scope, especially for large institutional investors.

Mr. Lemke closed the panel by noting that the 1940 Act, through the exemptive application process, provides a means to facilitate innovation, which is critical to the industry's ability to service investors' needs.

Workshop A: Tax Issues

Moderator:	Karen Lau Gibian, Assistant Counsel – Tax Law, Investment Company Institute
Speakers:	Shawn K. Baker, Principal, PricewaterhouseCoopers, LLP Samuel F. Beardsley, Vice President, T. Rowe Price Associates, Inc. Michael J. Desmond, Tax Legislative Counsel, U.S. Department of Treasury Brian Janssen, Director of Taxation, American Century Investments

Accounting for Uncertain Tax Positions – Financial Accounting Standards Board Interpretation No. 48 ("FIN 48"). Mr. Baker discussed issues associated with FIN 48. FIN 48, effective for fiscal years beginning after December 15, 2006, provides a two-step process for the recognition of tax positions ("benefits"). First a determination is made as to whether a tax benefit is more likely than not to be recognized. Second, the taxpayer is required to measure the amount of that benefit in cases where the position is uncertain. These rules have special implications for registered investment companies ("RICs") because of the impact on the daily calculation of net asset value ("NAV"). In particular, there is a concern that NAVs may be inappropriately reduced in scenarios where a possible tax is not paid because of Internal Revenue Service ("IRS") administrative practice, or where the tax will in fact be paid by another party, or in connection with tax positions taken under the lower tax reporting standard prior to the effectiveness of FIN 48 (*i.e.*, fiscal years beginning before December 16, 2006). In a response to several comments, including from the ICI, the SEC's Division of Investment Management and Office of Chief Accountant provided guidance in late December 2006 that clarifies that investment companies will first be required to comply with FIN 48 with respect to financial statements for the first fiscal period beginning after December 15, 2006 (in the case of a calendar-year fund, for example, June 30, 2007). Significantly, the guidance also clarifies that RICs can rely on informal IRS guidance in order to conclude that a particular position/tax benefit is more likely than not to be sustained.

<u>Targeted Subchapter M Reform</u>. Ms. Gibian asked whether some Subchapter M reform is necessary, and referred to the model of the Real Estate Investment Trust ("REIT") provisions, to which a series of technical changes have been made over the years, including ones that avoid disqualification by imposing 100% excise taxes in certain situations.

<u>Section 19 Notices Regarding Sources of Distributions</u>. Mr. Beardsley discussed sources of unclarity surrounding the application of Rule 19a-1 under the 1940 Act, including whether financial accounting or tax concepts govern the determination of the need for or nature of disclosure. He concluded that, generally speaking, financial accounting concepts govern this determination, and suggested that such disclosure assign distributions to one or more of three categories: (i) net investment income, (ii) returns of capital, and (iii) net profits (including both short- and long-term gains).

<u>REIT Taxable Mortgage Pools ("TMPs")</u>. Ms. Gibian discussed REIT TMPs. In recent years, REITs have started to securitize mortgage interests, and when they do so must pass on so-called "excess inclusion income" (EII), which is required to be taxed regardless of the tax status of the recipient to their shareholders. RICs (in particular, those that invest heavily in REITs) have found themselves having to meet uncertain obligations relating to the payment of tax in respect of such REIT holdings and inclusions, in particular in the case of three specific types of RIC shareholders:

- In the case of tax-exempt shareholders, EII can create unrelated business taxable income ("UBTI").
- In the case of charitable remainder trusts ("CRTs"), EII potentially "blew up" the funds (*i.e.*, disqualified for them as treatment as CRTs).
- In the case of foreign shareholders, EII can create income tax withholding obligations.

Late last year, the IRS issued Revenue Ruling Section 2006-58, ruling that EII is not UBTI to a CRT (*i.e.*, that Internal Revenue Code (the "Code") Section 664(c) does not apply to disqualify a CRT from such treatment). The ruling also provided that CRTs are so-called "disqualified organizations" under the REMIC residual interest provisions made applicable to REIT TMPs, with the result that a tax is imposed on an entity (or nominee) that allocates EII to a CRT. Accompanying Notice 2006-97 provided that the interim guidance applied to current and prior years, and further required REITs, RICs and nominees to allocate EII to their shareholders, to pay disqualified organization tax, and to withhold on distributions to foreign shareholders.

The ICI has submitted a request for further guidance, pointing out to the IRS that it is extremely difficult for RICs to identify shareholders that are disqualified organizations (including CRTs), that there are no rules for information reporting by REITs or RICs or for withholding on distributions to foreign shareholders, and that there is a need for a workable taxation and reporting regime before the guidance can be applied.

Information Reporting – Exempt Interest Dividends. Mr. Baker discussed information reporting of exempt interest dividends. As a result of a legislative change in 2005, information reporting is now required for tax-exempt interest income, including exempt interest dividends. IRS Notice 2006-93 provided that the proper form on which to provide this information for 2006 is Form 1099-INT, and that back-up withholding potentially applies to such payments notwithstanding their exempt character. The ICI has proposed to the IRS that RICs be able to use Form 1099-DIV for this purpose.

State Tax Issues. Mr. Janssen reported that the Kentucky Court of Appeals ruled last year that the commerce clause was violated when Kentucky exempted interest on its own state and local bonds from tax while taxing interest on other states' bonds. The Kentucky Supreme Court denied the state's motion for review. The only other case addressing this issue, in Ohio (in 1994), ruled this treatment permissible. The State of Kentucky has applied for certiorari. If the U.S. Supreme Court were to take the case and agree with the Kentucky Court of Appeals, each state would need to decide how to "level the playing field." That is, each state would be forced either to impose a tax on interest arising from all state and local obligations, including its own, or to exempt the interest on all such obligations from tax.

The panel discussed two other cases of potential interest to RICs. One case based the taxability of a credit card servicing company on the locations of its customers, rather than any other fiscal presence, in West Virginia (West Virginia Tax Commissioner vs. MBNA America Bank, *2005 WL 1978490*), and the other found that an intangibles holding company without physical presence in New Jersey had a taxable "nexus" in the state (Lanco, Inc. v. Director, Div. of Taxation, *188 N.J. 380 (2006)*), in each case by virtue of "significant economic presence" in the relevant state.

Workshop B: ERISA – Implementation of the Pension Protection Act

Moderator: Michael L. Hadley, Assistant Counsel – Pension Regulation, Investment Company Institute

Speakers: Lori E. Bostrom, Vice President and Senior Counsel, OppenheimerFunds, Inc.
Robert J. Doyle, Director, Office of Regulations and Interpretations, U.S. Department of Labor
William A. Schmidt, Partner, Kirkpatrick & Lockhart Preston Gates & Ellis LLP

Mr. Hadley noted that the Pension Protection Act of 2006 (the "PPA") had been signed into law in the year since the previous ICI conference. The workshop was devoted to considering issues associated with the implementation of the PPA.

Auto-Enrollment, Default Investments and Investment Mapping. Ms. Bostrom described the significance of Section 404(c) of the Employment Retirement Income Security Act as of 1974, as amended ("ERISA"), which protects fiduciaries of individual account plans against fiduciary breach claims where plan participants make their own affirmative investment decisions for their account assets. She noted that by adding new Section 404(c)(5) to ERISA, the PPA affirmed that a participant's lack of decision-making can itself be regarded as an investment decision for purposes of Section 404(c). Under Section 404(c)(5), if, in the absence of an affirmative election, a participant's account is invested in certain "qualified default investment alternatives" (described below), the participant will nevertheless be treated as having exercised control over such account, in which case the plan fiduciary may qualify for the protections of Section 404(c).

Ms. Bostrom reported that the PPA preempts state laws that might bar or restrict automatic deferral arrangements, and provides a conditional exclusion from the Code's non-discrimination tests for certain auto-enrollment plans. In order for an automatic enrollment plan to qualify for the PPA exclusion, employees must receive reasonable advance notice, a clear explanation of what will happen absent employee choice, and an opportunity for participants to revoke auto-enrollment within 90 days without incurring any tax penalty for early withdrawal.

Ms. Bostrom next described a proposed regulation issued by the Department of Labor ("DOL") concerning what may qualify as a "qualified default investment alternative" ("QDIA") for purposes of ERISA Section 404(c)(5). She noted that under the proposed regulation, a QDIA must be one of three types of investments: a life-cycle fund, a balanced fund, or a managed account that allocates assets among various plan options.

The panel discussed auto-enrollment and default investments. Ms. Bostrom was concerned that the advance notice requirement for auto-enrollment could result in employers being unable to begin automatic deductions with a new employee's first paycheck, which in turn could lead to employee dissatisfaction when deductions do begin and ultimately to reduced participation in plans. Mr. Doyle stated that the final rule will address this issue. Ms. Bostrom asked whether the DOL has considered expanding the list of potential QDIAs. Mr. Doyle stated that the DOL is working on this issue, and has been considering the views of the investment management and insurance industries. Mr. Doyle said that he expects a final QDIA rule to be issued in May.

Ms. Bostrom concluded by discussing "mapping" (removals and replacements of plan investment options). ERISA Section 404(c)(4) provides relief for plan years beginning after December 31, 2007, for qualified changes in investment options. In order to rely on this relief, plan sponsors will need to determine that a new or remaining investment option is reasonably similar to the previous option.

<u>Safest Available Annuity Standard</u>. Mr. Hadley recounted the history of the "safest available annuity" standard. DOL Interpretive Bulletin 95-1 ("IB 95-1") required that fiduciaries take steps to identify the safest available alternative when selecting an annuity provider. The DOL subsequently issued Advisory Opinion 2002-14A, which clarified that the principles of IB 95-1 extended to defined contribution plans. Advisory Opinion 2002-14A stated that while a fiduciary can take both the cost and the benefit of competing annuities into account, a lower cost can never justify an "unsafe" annuity. Mr. Hadley reported that Section 625 of the PPA essentially overruled Advisory Opinion 2002-14A by requiring the DOL to issue regulations by August 2007 exempting defined contribution plans from the safest available annuity standard.

Mr. Doyle confirmed that the DOL will be issuing regulations that will change existing guidance on annuities. The new regulations will state that IB 95-1 only applies to defined benefit plans, and will provide guidelines for defined contribution sponsors in choosing annuity products for their plans.

Plan Asset Regulations. Mr. Schmidt described provisions of the PPA that amend the ERISA plan asset regulations. The PPA made two significant changes to the "25% test" used to determine whether an unregistered fund is subject to ERISA as a result of significant investment by benefit plan investors. First, the definition of "benefit plan investor" for this purpose now excludes plans that are not subject to ERISA or Code Section 4975 (*e.g.*, foreign or governmental plans). Second, unregistered funds can now "look through" their fund-of-funds investors to count only the portion of such investors that are attributable to benefit plans.

Investment Advice Under the PPA. Mr. Schmidt summarized the PPA provisions concerning investment advice. Historically, ERISA fiduciaries were prohibited from providing "investment advice" that would result in the payment of an additional fee to the fiduciary or an affiliate. New ERISA Section 408(b)(14) gives relief for investment advice provided pursuant to an "eligible investment advice arrangement." Mr. Schmidt explained that this new investment advice exemption is complex, but generally requires that the advice be provided pursuant to either a level fee arrangement or a computer model that meets certain requirements.

Mr. Doyle reported that the DOL is drafting regulations, which it hopes to release by late summer, in connection with the new investment advice exemption, including identification of an appropriate computer model advice program.

Service Provider Exemption to Prohibited Transaction Rules. Mr. Schmidt described the new exemptions under the PPA to ERISA's prohibited transaction rules, focusing on the new service provider exemption found in ERISA Section 408(b)(17). He explained that the service provider exemption can exempt a broad range of transactions from the prohibited transaction rules, so long as the counterparty with respect to a transaction is a party in interest by reason of being (or being related to) a service provider, and is not a fiduciary with respect to the assets involved in the transaction. However, he cautioned that it is unclear to what extent the market will accept ERISA representations relying on the new service provider exemption in lieu of established exemptions such as the Qualified Professional Asset Manager ("QPAM") exemption.

Department of Labor Initiatives. Mr. Doyle discussed the DOL's current agenda. He stated that the DOL continues to focus on 401(k) plan fee disclosure. He noted the importance of ensuring that participants and beneficiaries have the information they need to make appropriate investment decisions. He explained that ERISA Section 408(b)(2), which requires that fees charged to ERISA plans be reasonable in relation to services provided, mandates disclosure to participants of compensation. He emphasized that any such disclosure should address potential conflicts of interest, including any revenue sharing arrangements. Mr. Doyle also noted that the DOL is considering an "innocent fiduciary" exemption from the prohibited transaction rules, which would give fiduciaries relief where a potential prohibited transaction had occurred solely due to the failure of a service provider to provide required information to a fiduciary.

Mr. Doyle then discussed Form 5500 and Schedule C. He noted that the DOL proposed changes to Schedule C last year, focusing on indirect compensation. He explained that the DOL was making some additional changes based on comments received, and that it hopes to issue a new Form 5500 in May. Mr. Doyle also noted that the DOL expects to mandate electronic reporting for Forms 5500, including Schedule C, beginning in plan year 2008 or 2009.

Mr. Doyle concluded that in his view, participant-level disclosure is the most challenging disclosure issue. He was encouraged by the discussions at the conference on simplification of mutual fund disclosure. He reported that the DOL will issue a formal request for information on this topic soon, and encouraged widespread participation by the benefit plan industry.

<u>Workshop C: International Issues</u>

Moderator: Glen S. Guymon, Assistant Counsel – International Affairs, Investment Company Institute

Speakers: Alison Fuller, Assistant Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission
C. Todd Gibson, Corporate Counsel, Federated Investors
Paul Harris, Partner, Linklaters
Murray L. Simpson, Executive Vice President, Franklin Templeton Investments

This panel examined (i) permissible investments for UCITS (defined below), (ii) cross border offerings of UCITS, (iii) the provision of cross-border advisory services, and (iv) the status of China's asset management market.

<u>UCITS</u>. Mr. Harris described the history of undertaking for collective investments in transferable securities ("UCITS"), a European Union directive implemented in 1985. UCITS could initially only invest in transferable securities, but a management directive adopted in 2002 expanded considerably the categories of eligible assets for investment. Mr. Harris noted that UCITS may now invest in a wide range of transferable securities, money market instruments, units of UCITS, deposits with credit institutions and financial derivatives.

Mr. Harris then discussed hedge funds, which are still an impermissible UCITS investment. Some UCITS had gained exposure to hedge funds by investing in indices based on hedge funds. Due to the divergence of regulators' views on this topic, the Committee of European Securities Regulators ("CESR") has prohibited national regulators from approving UCITS which utilize hedge fund indices. Mr. Harris stated that the CESR published a paper seeking further views on whether hedge fund indices should be considered a permissible investment for UCITS. The CESR is expected to publish a feedback statement in May 2007.

Ms. Fuller noted that the SEC has recently undertaken a review of investment companies' holdings in hedge funds. Mr. Harris observed that the CESR is concerned with diluting the relatively safe UCITS brand with more risky investments.

<u>Cross-Border Offerings</u>. Mr. Gibson then discussed the White Paper on Enhancing the Single Market Framework for Investment Funds issued by the European Commission ("EC") last November. To address concerns regarding the UCITS cross-border notification process, the EC has proposed a reduced waiting period, standardized documentation and a focus on regulator-to-regulator exchanges. To facilitate cross-border fund mergers, it is expected that tax-neutral arrangements that apply to most company mergers will be extended to mergers involving UCITS from different jurisdictions. The EC has also proposed reforms that would allow management companies to more easily manage funds in other Member States.

Mr. Harris then discussed shortcomings of the simplified prospectus and noted that the EC wants to create a document focused on charges, risks and expected performance.

Panelists considered a variety of other cross-border issues, including potential benefits from pooling UCITS with non-UCITS, the ability of U.S. investors to access foreign markets, a proposal to give foreign broker-dealers with substantially similar regulatory schemes access to U.S. markets, withholding tax and dividend issues surrounding the sale of U.S. funds abroad, including the sale of Treasury securities, and the sale of UCITS in Asia.

Cross-Border Advisory Services. Mr. Gibson began by noting that the provision of advisory services on a cross-border basis has become increasingly common and integral for future growth. He highlighted the need for an adviser to know its customers and know the location of the provision of advisory services due to the imposition of value added tax. Mr. Gibson discussed differences in standards of care, pointing out that several countries impose a statutory standard of "reasonable" care while others do not recognize a distinction between ordinary and gross negligence. He cautioned that cross-border advisory contracts should be read carefully to determine where any litigation would occur and which country's laws would apply.

Panelists reviewed the Markets in Financial Instruments Directive ("MiFID"), which will take effect on November 1, 2007. Mr. Gibson explained that MiFID is designed to harmonize the provision of cross-border advisory services by emphasizing home state supervision. He reported that most European countries will not have implemented MiFID by its deadline. Mr. Gibson next described MiFID's rules related to outsourcing, noting the considerable focus on the supervisory authority of the outsourcing institution. Mr. Gibson expressed his opinion that outsourcing institutions will be required to establish comprehensive reporting lines and mechanisms with their service providers in order to meet regulatory obligations.

China. Lastly, the panel discussed China's rapidly growing and highly regulated local asset management market. Mr. Simpson pointed out that China's stock market is less than ten years old. He noted that, over the past three years, the Chinese fund industry has experienced a compound annual growth rate of 70% and as of January 2007 had assets under management equivalent to $110 billion U.S. dollars. Mr. Simpson then pointed out that China's household savings rate of more than 40 percent is one of the highest in the world. He reported that mutual funds comprise over 50% of all trades conducted on the Shanghai Stock Exchange. Panelists agreed that tremendous opportunities for asset and product growth exist in China.

Workshop D: Trading and Brokerage

Moderator:	Ari Burstein, Senior Counsel, Securities Regulation – Capital Markets, Investment Company Institute
Speakers:	Kevin Cronin, Director of Equity Trading, AIM Investments John Giblin, Senior Vice President, Lehman Brothers Thomas S. Harman, Partner, Morgan, Lewis & Bockius LLP Elizabeth K. King, Associate Director, Division of Market Regulation, U.S. Securities and Exchange Commission Robert Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission

Soft Dollars. Mr. Plaze commented on various measures under consideration by the Staff to enhance transparency with respect to brokerage arrangements. The Staff is considering amendments to Part II of Form ADV in order to provide investors with better brokerage information, including a quantitative measure of soft dollar benefits. Mr. Plaze indicated that the Staff prefers a "market driven solution" to any rulemaking that would mandate the unbundling of execution services and research. He also noted that the Staff is studying developments in both the United States and the United Kingdom in connection with its review.

Mr. Giblin described client commission arrangements ("CCAs") and commission sharing arrangements ("CSAs"), and reviewed their key differences. A traditional soft dollar or CCA arrangement is one where the research broker is treated as a vendor, and is not required to play a role in effecting the transaction. Mr. Giblin contrasted this arrangement with CSA arrangements, which are arrangements whereby brokers share commissions. As a result, in a CSA, both brokers must be registered broker-dealers, and the research broker must also be involved in effecting the trade.

Mr. Cronin discussed his firm's use of CSAs, which he viewed as a valuable tool to obtain research. He also commented on the changing economics of brokerage arrangements, noting that while brokers make relatively little on agency business, they stay involved because the value of a trade is the information it contains. Mr. Harman noted the need to integrate the guidance provided in the SEC's 2006 soft dollar release, including the new vocabulary that it employs, in dealings between advisers and fund boards, in written compliance policies, and in disclosure documents such as Form ADVs and fund registration statements.

Mr. Harman discussed compliance issues raised by the changing brokerage landscape, including the need for enhanced documentation of practices. Mr. Plaze encouraged advisers to review their Form ADV disclosure frequently, especially in connection with any change in soft dollar practices. He also noted that, except in cases where the omission is particularly significant, the Staff's practice is to issue deficiency letters (as opposed to taking more serious action) in connection with discrepancies between Form ADV disclosure and actual practices.

<u>Confidentiality of Mutual Fund Trading Information</u>. Mr. Cronin discussed the economic value of trading information, and noted the concern expressed by many in the fund industry that stock prices paid by mutual funds are being adversely affected by information leakage. He cited possible sources of leakage, including the interaction of a broker's proprietary trading business with its agency business, and the possible sharing by brokers of important trading information with hedge funds or other large clients. As a result of the potential for such harmful activities, it is important to understand where leaks can occur, and to take steps to limit such risks.

Mr. Giblin observed that brokers also have powerful incentives to avoid information leakage, as such leaks could cause enormous reputational harm. In response to a question regarding the risks associated with "dark pools" he noted that while not immune to abuses, they were initially developed to keep trades away from exchanges, thereby limiting information flow and enhancing trade performance.

Ms. King discussed the SEC's related sweep examination of brokers. She noted that the SEC has received complaints of possible information leakage, and initiated the sweep as a means of looking for evidence of frontrunning. Mr. Burstein noted that this was a challenging exercise, as frontrunning transactions based on trading information leaked to hedge funds or other clients could have been executed at a different brokerage firm.

Impact of Globalization/Exchange Mergers. Mr. Cronin discussed the impact of globalization and exchange mergers on best execution. He noted that these developments have allowed his firm to get an early start on trading and thereby improve trade efficiency. Ms. King noted that as trading markets become more global, the SEC wants to be sure U.S. securities laws applicable to broker/dealers continue to be observed. She commented that what constitutes best execution is determined through a facts and circumstances analysis that needs to evolve as markets evolve.

Side-by-Side Management of Different Investment Products. Mr. Harman discussed compliance challenges posed by side-by-side management, including trade orders and trade allocations. He noted that there is no statutory duty for advisers to aggregate or disaggregate orders, or to allocate trades in a particular manner – rather, the obligation is to disclose any practice that could operate to the disadvantage of certain clients. Mr. Plaze noted that the Staff looks closely at arrangements where an adviser has a financial incentive (through incentive fees or otherwise) to treat one account more favorably than another. The Staff also looks carefully at order allocation, including how trade allocation procedures are implemented and any resulting performance dispersion. Mr. Plaze confirmed that the Staff views robust disclosure as tantamount to client consent, but also noted that disclosure is often vague or inadequate.

Gifts and Entertainment. Mr. Giblin commented that while enforcement actions have cast a brighter spotlight on gifts and entertainment policies in recent months, many firms have always maintained good documentation of such activities. Mr. Cronin noted that while some abuses had been uncovered, there is material benefit to clients of good relationships between the buy side and the sell side. Mr. Plaze noted that firms should have gift and entertainment policies in place. He observed that if the SEC were revisiting its compliance policies and procedures rulemaking today, gift and entertainment policies would be specifically referenced. Ms. King commented that the SEC was in the process of trying to reconcile proposed rules filed by the NYSE and NASD in 2006, and expects to publish a harmonized rule for comment shortly.

Use of Short Selling/Other Trading Strategies. Mr. Cronin observed that the increased use of short selling by mutual funds is not surprising, as the same process used by portfolio managers to identify securities to buy may also provide information as to what securities to sell. He noted that the recent relaxation of the "uptick rule" has created more opportunities to sell short, but has also forced fund companies to consider how to balance long and short client exposures. Mr. Harman noted there are several plausible explanations why an adviser might short a security for one client while holding a long position in the same security for another client, including differences in portfolio management teams, investment strategies and risk tolerance. He cautioned that appropriate compliance infrastructure must be in place before an adviser commences using short sales, and that fund boards must be kept informed of any changes in practices.

Workshop E: Variable Insurance Products

Moderator: David Pearlman, Senior Vice President & Deputy General Counsel, Fidelity Investments

Speakers: Thomas Conner, Partner, Sutherland, Asbill & Brennan LLP
Heather C. Harker, Vice President and Associate General Counsel, Genworth Financial, Inc.
Susan Nash, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission

Disclosure Reform. Mr. Conner reviewed the history of various disclosure reform initiatives, beginning with the introduction of the Statement of Additional Information for mutual funds in 1983. Simplifying amendments to Form N-6 (for variable life products) were adopted in 2002, but the SEC has never addressed simplifying amendments to Form N-4 (for variable annuities) proposed by the National Association for Variable Annuities in 1999. The adoption of the Sarbanes-Oxley Act in 2002 appeared to have deferred discussions of disclosure simplification. Mr. Conner noted that increasing complexity in variable annuity and variable life products serves to underscore both the need for and challenges to disclosure reform.

Ms. Nash explained that the SEC's principal goals with respect to disclosure reform – providing investors with the information they need and want, in a form and at a time that are useful – have not changed. The Staff is looking into ways in which technology can be used to "layer" disclosure, providing all investors with certain minimum information, generally of the type contemplated by Rule 498 for mutual fund profiles, while making other information available to investors on request. Ms. Nash noted the ICI's development of a proposed XBRL taxonomy, and the SEC's proposed voluntary filing of Risk/Return Summaries using XBRL tags. She stated that the Staff is considering a short-form disclosure document that would be delivered to all investors, with additional information (made more accessible through the use of XBRL tags) available upon request. In response to questions, Ms. Nash acknowledged that the scope and complexity of important information about variable annuities would present challenges to the preparation of a variable annuity profile.

Rule 22c-2 Shareholder Information Agreements. Ms. Harker reviewed the requirements of Rule 22c-2 under the 1940 Act with respect to shareholder information agreements. She described the wide variety of agreements being proposed by fund companies and explained intermediaries' practical need to ensure that responses to information requests can be automated. She noted that in the adopting release for amended Rule 22c-2, the SEC had affirmed its position that the Rule should not expose insurance companies to liability for breach of their variable contracts if they enforce underlying fund redemption fees or frequent trading policies.

Internet Proxy Rule. Mr. Pearlman reviewed the amendments to the proxy rules adopted in January 2007. In addition to adopting amendments permitting use of an Internet-based "notice and access" model, the SEC has proposed amendments that would require issuers to furnish proxy materials by posting them on an Internet website and providing notice of their availability. Mr. Pearlman explained that the SEC has not responded to the request by the Committee of Annuity Insurers that the role of insurance companies issuing variable annuity contracts as "intermediaries" be clarified. In response to questions, Ms. Nash stated that it is unlikely that the

SEC would relieve issuers and intermediaries of the responsibility to provide paper copies of materials on request.

Product Development Trends. Ms. Harker reviewed demographic trends and the U.S. Social Security Administration's own projected shortfalls to explain the increasing demand for insurance products to supplement Social Security and pension benefits. She reviewed various types of benefits available, and observed that the desire of investors to retain some participation in equity appreciation, while enjoying some guaranteed benefits, has led to increasingly complex products. Ms. Nash stated that she recently reviewed products in which the insurer retained the right to alter an investor's allocation under certain circumstances, and that the Staff has pressed the insurer for disclosure regarding the specific circumstances that would trigger the insurer's right to change the allocation. Ms. Nash also noted that a broker's suitability requirements may be implicated by the complexity of the product and the related disclosure. Ms. Hawker noted that care should be taken in developing new products in order to protect against the possible infringement of one or more "business method" patents.

Funds-of-Funds. Mr. Conner reviewed the use of insurance-dedicated funds-of-funds, explaining that the structure can help an insurer enhance diversification and manage allocation risk. He noted that the SEC recently adopted Rules 12d1-1, 12d1-2 and 12d1-3 under the 1940 Act, simplifying the process for establishing certain types of funds-of-funds. He cautioned that the sale of shares to a fund-of-funds can raise issues under the mixed and shared funding exemptive orders on which many insurance-dedicated funds rely. Ms. Nash stated that the Staff is currently working on four exemptive applications for insurance-dedicated funds-of-funds, and is requiring applicants to acknowledge that the receipt of compensation, in connection with the purchase or sale of securities by the fund-of-funds, by affiliates and second-tier affiliates of the fund-of-funds for effecting such purchase or sale is subject to Section 17(e) of the 1940 Act. She explained that the Staff is concerned about the conflict of interest faced by the adviser to the fund-of-funds in choosing the underlying funds, and that the Staff feels that insurance-dedicated funds-of-funds might be distinguishable from retail funds-of-funds because of the difficulty of identifying the legitimate services performed at each of three levels (underlying fund, fund-of-funds, and insurance company separate account).

Proposed NASD Rule 2821. Mr. Conner reviewed proposed NASD Rule 2821, relating to sales practices with respect to variable annuities. Ms. Nash said the Staff did not anticipate re-publishing the proposed rule or approving the proposed rule pursuant to delegated authority.

<u>General Session: The Regulatory Outlook for Mutual Funds</u>

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

Speakers: Andrew J. Donohue, Director, Division of Investment Management, U.S. Securities and Exchange Commission
Alan R. Dynner, Vice President and Chief Legal Officer, Eaton Vance Management
Jack Murphy, Partner, Dechert LLP
Kathryn L. Quirk, Vice President and Corporate Counsel, Prudential Investments

<u>Disclosure Initiatives</u>. Ms. Krentzman identified two disclosure initiatives that the SEC has publicly stated it is pursuing – development of a short form fund profile and "tagging" of risk-return information for funds using XBRL. She said that it appears the XBRL initiative is further along. Mr. Donohue said, however, that the development of the short form profile, which he referred to as a "profile plus," is the Division of Investment Management's main priority.

Mr. Murphy noted that the Staff considered a similar "fund profile" initiative in the late 1990s, and that the primary reason it failed, in his view, was that the SEC never adequately addressed liability issues related to the prospectus delivery requirements of Section 5 of the Securities Act of 1933, as amended (the "1933 Act"). Mr. Donohue responded that advances in technology have made the profile plus method more important and achievable, but acknowledged that unless the liability concerns are addressed, the initiative could fail. Mr. Dynner stated his view that any protection from liability should take the form of a rule, not mere comment or comfort from the Staff. Mr. Donohue responded that the Division intends in the 2nd or 3rd quarter of 2007 to request that the SEC adopt such a rule. Mr. Murphy said that he believed the SEC could, under its 1940 Act exemptive authority and the exemptive powers under the 1933 Act and the Securities Exchange Act of 1934, as amended (the "1934 Act"), granted to it by the National Securities Markets Improvement Act of 1996 ("NSMIA"), achieve this objective through the rule-making process.

Mr. Donohue stated his desire to cap fund profiles under the new initiative at two pages. Mr. Murphy questioned whether a two-page limit was possible, given the historical disclosure requests of the Staff. Mr. Donohue said that he would work with the Staff to maintain this limit, but that registrants also need to work to limit the information in the profile plus. He also raised the question of how often fund profiles would need to be updated, and Ms. Quirk expressed concern that quarterly updating could be expensive for fund shareholders.

With respect to XBRL, Mr. Donohue said that he believes more portions of a fund prospectus should be tagged eventually, but that the current initiative focuses on tagging the risk/return summary. He believes XBRL tagging will be a valuable tool for investors, and that it should eventually be mandatory. Ms. Quirk noted that today tagging is primarily done manually, and suggested that the SEC should not make tagging mandatory before software is available to tag data through an automated process. Mr. Donohue confirmed that no liability would attach to registrants engaged in voluntary tagging, and that this issue will need to be addressed before tagging is made mandatory.

Mr. Dynner questioned the basic premise behind these initiatives, asking what data the Division of Investment Management is relying upon in concluding that investors do not currently have access to the information they need. Mr. Donohue pointed to research conducted by the Staff in connection with the point of sale disclosure rule proposal, which he said indicated that investors were confused about basic information relating to funds and were generally overloaded with information they did not consider relevant. He noted that the use of hyperlinks in an internet based communication would give investors access to whatever information they considered relevant. Mr. Donohue recognized that many fund investors invest through intermediaries, but stated that these disclosure initiatives, especially XBRL, will help those intermediaries to serve their customers better. Mr. Donohue also stated that the Division hopes to cooperate with the Department of Labor to incorporate the proposed profile plus requirement into 401(k) disclosure.

Advisers Act Anti-Fraud Rule Proposal. Ms. Krentzman next raised the SEC proposal for new Rule 206(4)-8 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which she said would apply to advisers to registered investment companies, among others.

Mr. Murphy said that he is troubled by the proposed rule because it could be interpreted to impose on the registered adviser to a fund a duty to fund shareholders that had not previously existed. Mr. Donohue said that he believed care had been taken not to create a new fiduciary duty. He said that the purpose of the rule is simply to restore the SEC's ability to bring actions against advisers to collective investment vehicles under Section 206 of the Advisers Act, which was called into question by the recent decision in Goldstein v. Securities and Exchange Commission, *451 F.3d 873 (D.C. Cir. 2006)*. Mr. Donohue noted that the Division will consider this concern, which has been raised in written comments in response to the proposed rule. He also said that the Division will consider comments relating to the lack of scienter requirements under the proposed Rule.

Duties of Fund Directors. Ms. Krentzman then raised the question of whether fund directors are currently overloaded with responsibilities in overseeing funds.

Mr. Dynner said that he does not believe that fund directors are overloaded. While there are issues that need to be addressed with respect to board responsibilities, he held that the quality of oversight is a function of the quality of the individual board members and their independent counsel. Ms. Quirk disagreed, stating that over the years directors have become the default reviewer with respect to any new issue, whether the issue arises because of a new rule or exemptive relief obtained. She noted that in her view certain director responsibilities constitute "low hanging fruit" that could easily be assigned to other parties. She cited the review of Rule 17a-7 transactions as one example. Ms. Quirk also stated that the new Section 15(c) disclosure requirements have changed the nature of a fund board's review of fund contracts, and not necessarily for the better. Mr. Murphy pointed out that fund directors have the benefit of the business judgment rule, and should be entitled to rely on fund advisers' responses to inquiries without significant additional review. He also noted that where further review of details is required, a fund's chief compliance officer ("CCO") can conduct such a review on behalf of the board. Ms. Quirk said that in practice fund directors do focus on such details because there is no clear guidance as to how detailed their review has to be in particular circumstances.

Mr. Donohue stated that he has begun a process of outreach to directors by attending board meetings of various fund complexes. His goal, he said, is to hear directly from directors as to where the Staff could help them be more effective. Ms. Quirk said that guidance would be helpful in areas such as board review of fair valuation, soft dollars and 12b-1 plans. Mr. Donohue said that the Division is looking at each of these areas. With respect to Rule 12b-1 plans, he said it was clear that the factors identified in the original release were not helpful in the context of reviewing 12b-1 plans in the current marketplace. In response to an audience question, Mr. Donohue said that the Staff's review of Rule 12b-1 would consider all options, including possible repeal of the Rule.

Soft Dollars. Ms. Krentzman next asked what issues remain unsettled after the recent guidance on soft dollar arrangements. Ms. Quirk reiterated her concern that it is unclear how thorough a board's review of an adviser's soft dollar arrangements needs to be. Mr. Donohue stated that fund directors play a valuable role in reviewing benefits from soft dollar arrangements to fund shareholders, and should be mindful of the benefits received by fund shareholders as compared to other clients of the adviser. He agreed that directors need a better sense of what they should review in this context, but that the conflicts of interest inherent in brokerage and allocation continue to require board oversight.

Mr. Murphy stated his view that the focus of soft dollar regulation should be on the total amount of brokerage commissions (and whether such amounts represent best execution), not how commissions are spent, arguing that shareholders care more about the bottom line. Mr. Donohue disagreed, stating that there are valuable benefits associated with using soft dollars, and that fund directors should review brokerage costs in this context precisely because it is not possible for shareholders to do so on a meaningful basis.

Record-keeping Rules. Ms. Krentzman then asked the panel to comment on issues relating to maintenance of books and records of funds and advisers. Ms. Quirk said that the most pressing issues relate to maintenance of electronic mail and instant messages. Mr. Dynner noted the overwhelming amount of data generated by such communications, and the challenges posed by storage of this voluminous data and compliance with applicable record-keeping rules. Mr. Donohue stated that the Staff is in the process of meeting with industry participants to learn about current practices and challenges. New rules will be developed that address three questions. First, what records are required to be kept for all funds and advisers? Second, what records, should one choose to have them, are required to be kept? With respect to both of these questions, he said, the rules will need to address how long records must be kept and in what format. The final question the new rules need to address, he said, was what access should the SEC and its Staff have to such records, and in what format? Mr. Donohue said that because these are difficult questions, any rule-making will be the result of a deliberative process that will take some time.

Rule 22c-2. Ms. Krentzman asked the panelists to comment on issues arising with the looming compliance deadline for agreements with intermediaries to satisfy the new redemption fee rule. Mr. Murphy discussed concerns about the use of a negative consent process to comply with the requirement to have agreements with intermediaries. He suggested that a course of conduct by an intermediary following the compliance date (*e.g.*, selling fund shares, collecting 12b-1 fees) could constitute ratification by action, and that fund companies could reasonably expect that such intermediaries will comply with the requirements of the Rule, as the intermediaries could not expect to receive the benefits of an arrangement without assuming the required obligations. Ms. Quirk stated that the next challenge, after signing the agreements, will be to determine how best to review the data that funds will receive from intermediaries. She predicted that some companies will use a third-party service provider to review the data. She also expressed a concern that fund companies will eventually be expected to review the data for information related to matters other than market timing. Ms. Krentzman said that she did not believe this was likely, as the adopting release addressed that issue and because the data was not configured for other uses (such as reviewing for anti-money laundering issues).

Miscellaneous Issues. Audience members raised several additional questions. In response to one question, Mr. Donohue said that a new proposed rule with respect to managers of managers will be released shortly. In response to a question regarding exemptive applications, Mr. Donohue stated that such applications are extraordinarily important for innovation in the industry. He stated that certain changes have been made to the process to keep applicants informed of progress, and that the Staff has committed to doubling the number of substantive applications processed in 2007 as compared to 2006. He said that the Staff is well on its way to meeting that commitment. An audience member asked the panelists to comment on the success of Rule 38a-1 under the 1940 Act (the compliance rule). Mr. Dynner stated that the Rule has had a beneficial effect by requiring fund companies to formalize their compliance programs. Ms. Krentzman cautioned against a "one size fits all" approach to compliance. Mr. Donohue noted the SEC's investor outreach efforts on this question. He further noted that many in the industry want more matters to be shifted from the purview of the board to the CCO, but that he is skeptical of instituting such a shift now because the CCO does not fill the same role in every organization, and because it is not yet clear whether CCOs have too many responsibilities already.

Finally, Mr. Dynner asked Mr. Donohue if, in addition to the ambitious regulatory agenda discussed at the conference, he also has a legislative agenda. Mr. Donohue said that he does not, noting that the 1940 Act provides broad exemptive authority to the SEC, and that he intends to use this authority to pursue the agenda he outlined during the panel discussion.

Panel 1-A: Complex Fund Investments

Moderator:	J. Stephen King, Jr., Senior Vice President, Legal and Compliance, PIMCO LLC
Speakers:	Chad Burhance, Director of Risk and Analytics Services, International Fund Services LLC, State Street Corporation Susan Ervin, Partner, Dechert LLP Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission Arthur Steinmetz, Senior Vice President/Portfolio Manager, OppenheimerFunds

Use of Derivatives. Mr. Steinmetz began the discussion by claiming that derivative transactions simplify portfolio management because they allow portfolio managers to isolate and take positions with respect to specific risk metrics (*e.g.*, long-term interest rates). He said that ideally he would invest in "plain vanilla" benchmark securities and generate a portfolio's "alpha" through investments in derivatives. He noted that the use of derivatives creates additional risks, particularly counterparty risk, settlement risk, documentation risk and regulatory risk.

Mr. Steinmetz then discussed the types of derivatives he uses, which include index and interest rate futures, interest rate swaps, total return swaps, credit default swaps, structured notes, options and “swaptions” (options on swaps) and insurance-linked bonds. Mr. Steinmetz objected to the characterization of credit default swaps as “insurance”; he said they are better described as a method of taking a long or short position in a security or index without actually transacting in that security or index. He noted that credit default swaps are sometimes structured to transfer a “slice” of risk (for example, the second 10% of principal losses), similar to structures used in collateralized debt obligation instruments. He said that he is using structured notes less frequently, in part because the need to make an up-front payment to purchase the note increases counterparty risk. He said that catastrophe bonds are subject to a type of prepayment risk because the sponsor can cause the issuer to default on the bonds if it believes that the yields on the bonds are too high for current market conditions. Because the bonds’ principal is typically held in an escrow structure for the benefit of bondholders, the bondholders would get their principal back in the event of default but would be required to reinvest that principal in lower-yielding investments.

Compliance Issues. Mr. Burhance then discussed compliance issues associated with complex fund investments. He first noted that the data requirements for tracking the terms of derivative instruments are becoming more complex and that technology has not fully caught up to this complexity. He said that missing or incorrectly capturing even a minor term of a transaction can cause errors in portfolio tracking, payment and settlement, risk management and valuation.

Mr. Burhance said that the risk management process is heavily dependent on the ability to quickly and accurately capture the terms of a transaction and to value the transaction on an ongoing basis. He also said that portfolio managers and traders may not be as sensitive to risk management issues and processes as risk management personnel, and that one of the increasing challenges faced by firms is ensuring that risk management personnel have the same valuation processes as portfolio management personnel. He cited as an example the need to have consistent and accurate valuations in “value at risk” models.

In response to a question, Mr. Steinmetz discussed how he monitors counterparty risk. He said that it is done “real time” and that he seeks to use counterparties with “sterling” credit ratings. However, he cautioned that counterparty diversification and monitoring may be of limited utility in reducing “systemic” risk because of the exposure counterparties have to other financial institutions. He said that lawyers review his firm’s derivatives documentation. He also said that he was hopeful that an additional “novation protocol” would be in place within a year making it easier to transfer positions. He said that this would allow investors to exit positions without having to rely on the original counterparty to unwind the transaction or to enter into an offsetting transaction with another counterparty (which he said increases counterparty risk).

Legal Issues Associated with Derivatives. Ms. Ervin then discussed legal issues affecting registered investment companies that use derivatives. She noted that the vast majority of instruments in use today did not exist in 1940 and in many respects are fundamentally different from typical “securities.” She noted that there are uncertainties in the treatment of derivatives under both the 1940 Act and Subchapter M of the Code.

Ms. Ervin described the analysis of a derivatives transaction as having six components:

- Defining the derivatives exposure. She said that every derivatives transaction has two exposures: (1) to the counterparty, and (2) to the reference asset(s), such as a security, index, foreign currency, commodity, economic indicator, credit event or other event (*e.g.*, a weather catastrophe). She said that having two exposures is relevant in a number of contexts, including Rule 35d-1 under the 1940 Act (the "names rule"), 1940 Act and Subchapter M diversification tests, Subchapter M's qualifying income test and Section 12(d)(3)'s limitation on investments in securities of securities-related issuers.

- Determining product type and design. She said that different types of derivatives can be used to obtain exposure to the same reference asset, and cautioned that different derivatives may be treated differently for various tests under the 1940 Act and Subchapter M.

- Valuation of a derivative. Ms. Ervin said that valuation is very important for determining compliance with the standards listed above as well as with liquidity and senior security/asset coverage requirements. She noted that it is not always clear whether the "value" of a derivative transaction for these purposes should be considered the "notional" value or the "current market value" of the transaction. She noted that recent fund registration statements disclose that for purposes of the 1940 Act's asset coverage requirements such funds would be valuing futures and forward contracts that are contractually required to cash settle at their current market value rather than their notional value. She said that the industry generally values swaps at current market value rather than notional value for such purposes. She also cautioned that using current market value might underestimate exposure for determining compliance with other requirements, such as those under Rule 35d-1.

- Rights and duties over the product lifecycle. Ms. Ervin observed that obligations under exchange-listed derivatives are generally defined by the rules of the exchange, while obligations under over-the-counter derivatives are generally a matter of contract. She said that these obligations are complex, can vary widely and often impose "springing" obligations such as reporting and collateral requirements triggered by net asset value declines. She cautioned that funds should know these requirements and be able to track them.

- Derivatives as part of the product matrix. Ms. Ervin warned that funds need procedures for managing and reviewing derivative documentation, including confirmations, and also monitoring the obligations under those transactions. She noted that lack of standardization is an issue; although the use of ISDAs provides some level of standardization, these agreements are often customized on a transaction-by-transaction basis and even the standard documents are periodically revised.

- Derivatives as part of an integrated and largely unregulated marketplace. She said that the derivatives markets are largely unregulated and decentralized, with many terms and conditions determined by market trends and regulatory concerns.

SEC Perspective. Mr. King then posed several questions to Mr. Scheidt. Mr. Scheidt stated that the Division of Investment Management understands that funds are operating with incomplete guidance and that current guidance is in need of modernization. He said that the Division is considering providing guidance on asset segregation requirements as well as with respect to senior securities issues more generally. He said that the Division is receptive to providing guidance but seldom receives such requests.

Mr. Scheidt divided his remarks into five general topics:

- Risk management. Mr. Scheidt said that although there is no specific regulatory requirement that fund advisers have risk management systems, advisers using derivatives should expect the Staff to ask "do you know what you are doing?" He said that the Staff would be seeking to determine whether a firm understands how the derivatives it is using work, how to account for them, the risks involved, both in isolation and in connection with the entire portfolio, and whether their use is consistent with disclosure provided to investors. He also said that the Staff would be seeking to determine whether a firm sets parameters for risks and monitors compliance with those parameters.

- Documentation. Mr. Scheidt noted that credit, market and legal risks can be exacerbated by documentation issues. He said that although much work has been done to improve documentation and matching and settlement processes, more needs to be done. He said that automation is important, claiming that many problems have arisen because of increased trading volumes, which make it difficult to manually track transactions.

- Disclosure. He said it is important that funds effectively communicate to investors and boards of directors the risks of investing in complex instruments. He said it is also important to communicate these risks to the financial intermediaries who sell fund shares so that they know what they are selling – in this regard, he referred to statements in earlier panels that investors do not read fund prospectuses. He said that disclosure should not include boilerplate and theoretical risks, but instead should describe the role played by derivatives in a fund's portfolio and the risks they add to the portfolio. He also said that the types of derivatives that can be used should be listed.

- Valuation. Mr. Scheidt admitted that SEC and Staff guidance on valuation is in need of modernization. He said that funds should consider the inputs driving valuations provided by counterparties and portfolio managers and whether the adviser believes it could sell its position for the value provided. He said that firms should consider the following:

  - What was it that made the portfolio manager think that the derivative was a good investment idea?
  - Has anything changed since then?
  - If the data that factored into the valuation of the initial transaction changes from day to day, shouldn't the valuation also change, especially if the initial price wouldn't have been the same if entered into today?

  He also noted that valuation transparency, methodology and sources are all important.

- Asset segregation. Mr. Scheidt commended Ms. Ervin's outline for explaining the issues associated with asset segregation. He noted that the Staff has done much work, but appreciates the complexity of these issues and is proceeding cautiously. He said the Staff is considering providing guidance on the asset coverage requirements for a wide variety of instruments (in particular cash settled futures and forwards and swaps). He also said that the Staff is considering providing guidance as to whether certain instruments, some of which are clearly not securities for purposes of the 1933 Act, should be considered securities for purposes of the 1940 Act. He said that he understands any such guidance would have significant implications for both registered and unregistered funds.

Discussion. In response to a question, Mr. Scheidt indicated that the Staff position is that the asset segregation requirements for cash settled futures and forward contracts is based on market value, not notional value.

In response to another question, Mr. Steinmetz discussed the interrelationship between the use of derivatives and an adviser's obligation to seek best execution. He said that although many derivatives are customized, the derivative markets are nevertheless competitive. He said that he typically discusses a transaction with more than one dealer, but also said that because the transactions are research intensive, dealers are rewarded for good research.

In response to a question on custody of swaps documentation, Ms. Ervin noted that the industry practice is for funds to place swaps documentation with their custodian. Mr. Scheidt said he had not developed a view on this issue, but said that keeping the documentation with the fund's custodian seems "silly."

Panel 2-A: Responsibilities of Fund Officers and Directors

Moderator:	Amy B. R. Lancellotta, Managing Director, Independent Directors Council
Speakers:	Paul Goucher, Managing Director and Associate General Counsel, J. & W. Seligman & Co. Incorporated Karrie McMillan, Partner, Willkie Farr & Gallagher LLP Barry Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission Steven J. Paggioli, Trustee, Professionally Managed Portfolios Michael S. Scofield, Chairman, Evergreen Board of Trustees

The panel discussed the evolving roles and responsibilities of fund directors and officers and related developments.

Ms. Lancellotta began by highlighting comments made by Mr. Donohue, Director of the Division of Investment Management, earlier at the conference regarding the Division's focus on the roles and responsibilities of fund directors. She noted Mr. Donohue's observation that the Division is reaching out to and gaining input and insight from fund directors.

Ms. McMillan recounted regulatory and other developments that have led to an expanded role for fund boards, including the recent market timing and revenue sharing regulatory matters, the adoption of Rule 38a-1 under the 1940 Act and development of related compliance programs, the adoption of Rule 22c-2 under the 1940 Act and board approval of redemption fees, the adoption of new fund governance rules, and enhanced disclosure requirements relating to board approval of investment advisory agreements. She suggested that fund directors, and particularly independent directors, are being asked to assume more "hands-on" responsibilities that seem to go beyond the "watchdog"/oversight role originally intended for them.

Communications with Boards. Messrs. Paggioli and Scofield, commenting on their experiences as independent fund directors, shared the view that the expanding regulatory environment for funds, including the developments noted by Ms. McMillan, have created new challenges for fund directors in identifying potential conflicts of interest between funds and their service providers and in determining what information should be brought to the attention of directors. They suggested that fund management has tended to react by overloading boards with information to avoid hindsight accusations by regulators or litigants that management has not been forthcoming with the directors. They further suggested that this approach can lead to overly voluminous meeting materials and lengthy meetings, and can obscure important topics and related information. Mr. Goucher suggested that the SEC or the Division of Investment Management could be helpful in this regard by providing additional guidance as to the scope and content of information that boards should review and/or by amending 1940 Act rules to make clear that delegates of the board, such as the chief compliance officer, can appropriately review information on the board's behalf, so that the board may focus on non-routine or exceptional items.

Messrs. Paggioli and Scofield agreed that a fund's CCO and his or her staff, or separate staff of the independent directors, could take on an expanded role as intermediaries between management and the board by sorting through information and identifying important topics and issues on which the directors should focus. Mr. Paggioli noted, however, that this approach may not be available to smaller fund groups that can not as easily bear the costs associated with additional staff for the CCO or the independent directors.

Reiterating a point made by Mr. Donohue earlier at the conference, Mr. Miller said that CCOs can serve a useful role in reducing the burdens of fund directors, but that each board needs to consider whether its CCO is the right person to take on these responsibilities in light of his or her particular skills and workload. Mr. Miller noted that, while 1940 Act provisions such as Rules 17a-7 and 10f-3 tend to result in routine reports to the board, the rules relate to potential conflicts of interest and by their terms require that boards make periodic determinations regarding related fund transactions. He said that the Division of Investment Management may consider possible modifications to these and other rules as part of its overall initiative to improve the effectiveness of fund boards, but stressed that funds must continue to comply with the associated board reporting and review requirements unless and until changes are made.

Messrs. Paggioli and Scofield then discussed formal and informal communication practices used by the fund boards on which they serve. Mr. Paggioli said that the annual board self-assessment required under the new fund governance rules has served as a useful forum for discussing and improving board communications and information-sharing practices. He noted, for example, that a fund board on which he serves instituted a practice whereby management provides meeting materials (*e.g.*, performance information) when they become available, rather than waiting until all materials are finalized closer to the meeting. Citing another example, he said that a board on which he serves determined to schedule periodic, half-day sessions with senior management devoted exclusively to strategic planning and related business topics, which tend to get less attention when included with the regular fund agenda. Mr. Scofield said that the board on which he serves uses a robust committee structure, pursuant to which the committees hold concurrent meetings that focus on specific areas (*e.g.*, audit, distribution, performance). He said that, in his capacity as independent chairman, he has frequent informal communications with management and committee chairs in between regular meetings. Mr. Scofield noted that the board on which he serves also utilizes a part-time consultant who was formerly employed by the investment adviser. He said that staff devoted to the independent directors can be very effective at working with management to organize and improve board communications and distill information into formats that are most useful to the directors.

Oversight of Service Providers. Ms. Lancellotta noted that the recent SEC enforcement actions involving fund transfer agents and administrators have brought into focus additional potential conflicts of interest for the fund industry, and raise questions as to the level of oversight and scrutiny that directors should apply to funds' arrangements with service providers.

Mr. Paggioli said that, in contrast to the fairly well-defined course of conduct fund boards follow in reviewing and approving investment advisory arrangements under Section 15(c) of the 1940 Act, there appears to be significant uncertainty among directors as to what their role should be in reviewing, approving and monitoring arrangements with other fund service providers, such as administrators, transfer agents and custodians. Mr. Paggioli reported that the Independent Directors Counsel (IDC) of the ICI is in the process of developing a "white paper" devoted to this topic, noting that he serves as chair of the IDC's Task Force on Oversight of Service Providers responsible for the project. He said that the white paper will be designed to provide guidance to fund boards, in part, by identifying various potential conflicts of interest and other issues raised by particular categories of fund service providers and suggesting questions and considerations that directors might ask and take into account when reviewing related fund arrangements.

Mr. Goucher suggested that, notwithstanding the recent regulatory actions, fund boards should not assume that they must closely scrutinize or become involved directly in negotiating standard business and legal terms of arrangements with fund service providers, or take a "hands-on" role in overseeing a service provider's day-to-day activities on behalf of funds. He said that boards should instead identify and focus on areas where potential conflicts of interest exist and insist on full and open disclosure from management regarding these areas. Mr. Scofield noted that the level of oversight should be higher when considering arrangements with affiliates of the investment adviser.

Mr. Scofield suggested that it may be prudent in some cases for boards to arrange for independent consultants to periodically review and assess a fund's arrangements with its service providers, including an assessment of the fees and expenses borne by shareholders in comparison to those of other fund groups. Ms. McMillan agreed, but cautioned that boards and management should think carefully before undertaking a request for proposal ("RFP") process, particularly if there are no significant problems with the current service provider, and should avoid conducting an RFP unless there is a true intention to change service providers. She noted that a full RFP process can be complicated, time consuming and expensive, and may lead to service quality and employee retention problems with the current service provider. She added that any eventual conversion to a new service provider, such as a transfer agent or custodian, promises to be an arduous and potentially risky endeavor in terms of compliance and maintaining the quality of shareholder services.

Rule 38a-1 and Related Oversight. The panelists generally agreed that Rule 38a-1 under the 1940 Act is an effective regulation and that the transition to compliance with the new rule has gone fairly smoothly. They also agreed that the CCO required by the rule serves a critical and helpful role for fund boards in satisfying their oversight responsibilities.

Mr. Goucher said that, in his experience, robust formal and informal reporting processes have developed between CCOs and fund boards, ranging from the written annual report required under Rule 38a-1 and scheduled executive sessions with the CCO, to informal conversations between the CCO and directors (such as a board or committee chair) when significant compliance matters arise in between regular meetings. Messrs. Paggioli and Scofield concurred, noting that the fund boards on which they serve have developed open lines of communication with the CCO and held frequent meetings and calls with the CCO during the transition to compliance with the new rule and in preparation for the initial annual CCO report. Mr. Scofield recommended that boards focus on promoting the critical education and training function a CCO can provide to prevent compliance problems, rather than necessarily viewing the CCO as a "cop on the beat" whose principal purpose is to detect and report violations.

Mr. Goucher suggested that CCOs report material compliance matters to boards as they arise, perhaps with a call to the board or a committee chair followed by a report at the next regular board meeting. He suggested that CCOs err on the side of caution by including both material and immaterial compliance matters in their annual reports, in part, due to the lack of clear guidance as to what is "material" for these purposes.

Mr. Miller noted that the SEC inspection staff has reviewed a number of annual reports issued by CCOs under Rule 38a-1, and has found a broad range in the scope and content of the reports. He said that the Staff recognizes that the rule is relatively new and that CCO reporting practices are still being refined and are likely to differ among fund groups.

Mr. Miller reminded the group that Rule 38a-1 calls for policies and procedures reasonably designed to prevent any violation of the federal securities laws (as defined in the rule), including those that may seem relatively minor or do not involve potential conflicts of interest. By way of example, he noted that the Staff has discovered that a number of funds have failed to file copies of their Section 17(g) fidelity bonds via EDGAR as is now required by Rule 101 of Regulation S-T. He suggested that CCOs and fund boards continually review and update compliance policies and procedures to ensure that they cover all applicable requirements, including new rules and amendments to existing ones. In response to a question from the audience, Mr. Miller indicated that violations of routine filing requirements (such as the fidelity bond example) can amount to material compliance matters that should be reported to the board under Rule 38a-1, particularly where they may raise concerns that other basic requirements are not being satisfied.

Enhanced Disclosure Regarding Advisory Contract Approvals / Section 15(c). Mr. Miller discussed the Staff's experience to date with the rules adopted in 2004 requiring that funds disclose in shareholder reports and applicable proxy statements the material factors and conclusions that formed the basis for board approval of investment advisory agreements under Section 15(c) of the 1940 Act ("15(c) Disclosure"). He said that the Staff has reviewed and commented on 15(c) Disclosure provided by many fund groups, and has seen a broad range of approaches, ranging from relatively sparse to very detailed disclosure. Mr. Miller noted a number of topics that the Staff likes to see included in 15(c) Disclosure, including (i) a description of the board's review process, such as the number of meetings held and the types of information and reports provided to the board, (ii) a description of the various services provided by the investment adviser and its affiliates to the fund, and (iii) a description of any steps recommended or taken by the board or the investment adviser to address funds with poor performance (*e.g.*, replacing a portfolio manager) or relatively high fees or expenses (*e.g.*, fee waivers or breakpoints). He said that the Staff will comment negatively when it reviews "boilerplate" disclosure that fails to differentiate among funds or to discuss all of the material factors considered by the board. Mr. Miller said that, in his view, the new disclosure requirements have generally led to a more robust board review process under Section 15(c).

Messrs. Paggioli and Scofield generally shared the view that, while the new disclosure rules have drawbacks, overall they have had a positive effect on the board review process and have resulted in more focused discussions between the independent directors and management. Mr. Goucher and Ms. McMillan expressed some concern that the new rules have been costly to implement, have not resulted in particularly meaningful information for shareholders and may ultimately be used as a "roadmap" for litigation. As to the last point, Mr. Scofield stressed the importance of having experienced legal counsel involved in the board review process and in drafting 15(c) Disclosure.

<u>Panel 3-A: 401(k) Plans at Age 25: Possible Judicial, Legislative and Regulatory Developments on the Horizon</u>

Moderator: William J. Kilberg, Senior Partner, Gibson, Dunn & Crutcher LLP

Speakers: Joseph Healy, Director, Defined Contribution Product Management, AllianceBernstein
Catherine Heron, Senior Vice President, Capital Research and Management Company
Sarah Holden, Senior Economist – Retirement, Tax & International Research, Investment Company Institute
Bill Sweetnam, Partner, Groom Law Group

Mr. Kilberg opened with a brief historical review, noting that Section 401(k) was added to the Internal Revenue Code in 1978 to permit employees to defer non-salary compensation (*i.e.*, year-end bonuses) in compensation deferral plans. In 1981, the Internal Revenue Service permitted deferral of salary compensation as well – and the rest, said Mr. Kilberg, "is history." There is now more than $2.4 trillion in 401(k) plans. Mr. Kilberg observed that, while defined contribution plans, such as 401(k) plans, have grown in popularity, defined benefit plans have declined.

<u>401(k) Plans</u>. Ms. Holden described the growth of 401(k) plans in detail, noting that over the past 20 years, 401(k) plans have become increasingly important defined contribution vehicles, measured both by assets and number of active participants. At the end of 2005, defined contribution plans, such as 401(k) plans, accounted for almost a quarter of U.S. retirement savings, which is about the same amount as IRAs. Although the current asset size of IRAs and defined contribution plans is approximately equal, Ms. Holden pointed out that this understates

the relative importance of 401(k) plans because a very significant source of IRA assets is 401(k) plan assets that are rolled over by 401(k) plan participants when changing jobs.

Ms. Holden reported that approximately 50% of 401(k) plan assets are invested in mutual funds. The trend is in favor of no-load mutual funds, or load-waived class A shares of mutual funds that do impose a sales charge. The trend is also towards low-cost funds – in 2005, 22% of 401(k) stock mutual fund assets were invested in funds with total expense ratios of less than 0.50%, and an additional 55% of these assets were invested in funds with total expense ratios between 0.50% and 1.00%.

Ms. Holden said that employee participation in 401(k) plans has been increasing, reaching 70% in 2003 (for civilian nonagricultural wage and salary workers aged 16 and over at companies sponsoring a 401(k) plan). She expected that participation will continue to increase as a result of automatic enrollment, as encouraged by the PPA, the increasing use of lifecycle and lifestyle funds as 401(k) investment options, which reduces the monitoring burden on participants, and the availability of Roth 401(k) plans. Ms. Holden cautioned, however, that increased participation in 401(k) plans does not necessarily mean that Americans are more prepared for retirement, because 401(k) plans are increasingly stand-alone retirement plans rather than supplements to defined benefit plans.

Ms. Heron addressed 401(k) plan fees, focusing on the fact that current disclosure requirements are designed to provide plan sponsors with the information they need to discharge their fiduciary duties in keeping plan expenses reasonable, but that this disclosure is not necessarily adequate for plan participants. According to Ms. Heron, this focus on plan sponsors made sense when defined benefit plans were the norm, as it was the plan sponsors who bore investment risk. Now, however, participants in defined contribution plans generally bear the investment risk and have a corresponding need to understand expenses that might affect their investment returns. Ms. Heron reported that as a result of this disconnect between regulatory requirements and participant needs, the media, Congress, and plaintiffs are focused on the adequacy and transparency of fee disclosure.

Ms. Heron reviewed a number of initiatives relating to fee disclosure, including, among others:

- a Department of Labor proposal to amend Form 5500 to require additional disclosure regarding compensation payments made (but Ms. Heron queried whether an IRS form is an effective disclosure document);

- ERISA Advisory Council suggestions for additional disclosure for plan participants, such as delivering a profile prospectus for each plan option upon participant enrollment (even for plan options that are not registered investment companies), providing educational materials explaining expense ratios and the profile, and providing information about expenses associated with each investment option in the participant's annual statement; and

- DOL consideration of possible amendments to regulations under Section 408(b)(2) of ERISA. The regulations currently permit a plan fiduciary to pay "reasonable compensation" to a service provider. The amendments would deem compensation that is inadequately disclosed to be unreasonable. (Ms. Heron said that there is some debate regarding plan sponsors' duties with respect to particular elements of compensation. In her view, plan sponsors are required to make sure that the investment is prudent and that the total expenses are reasonable; they are not required to determine that each element of expense is reasonable.)

Ms. Heron said that the SEC has been relatively inactive. Ms. Heron observed that the SEC's 1992 "Red Book" study noted that retirement plan disclosure is outdated because it is geared towards the defined benefit plan marketplace, but recommended legislation and rules to address this problem were never adopted. Ms. Heron also noted that in 2005, the SEC issued a report focused on the independence of advice and disclosure of conflicts of interest. In this regard, Ms. Heron said, there is joint DOL/SEC guidance regarding the duties of plan sponsors with respect to pension consultants. She predicted regulation in this area, and noted that coordination between the DOL and the SEC will be critical.

Congressional Activity and Litigation. Mr. Sweetnam then addressed Congressional activity and litigation relating to 401(k) plans. He said that, in general, Congress would like to see increased participation in 401(k) plans and decreased plan fees. He said that the Government Accountability Office (GAO) concluded, in a November 2006 study, that the DOL does not have sufficient information about 401(k) plan fees, and that additional legislation may be necessary. He said that there appears to be bipartisan interest in Congress in assessing whether additional disclosure should be required.

Mr. Sweetnam then reviewed three types of litigation – class action lawsuits against plan sponsors, class action lawsuits against service providers, and settlements with the New York Attorney General. Mr. Sweetnam reported that the law firm Schlicter Bogard & Denton LLP has filed twelve lawsuits against corporations (including Boeing, Caterpillar, Exelon and Bechtel) that are plan sponsors, alleging that the corporations' 401(k) plans have been charged excessive and improper fees and that these fees and revenue sharing payments have not been adequately disclosed to plan participants. Mr. Sweetnam said that these cases are in early stages, but noted that the suit against Exelon has been dismissed, and the Boeing case has been transferred from the District of Southern Illinois (which Mr. Sweetnam characterized as "plaintiff heaven") to the District of Northern Illinois.

Turning to the class action lawsuits against service providers, Mr. Sweetnam described Haddock v. Nationwide Financial Services Inc. *419 F.Supp.2d 156 (D.Conn. 2006)*, in which the plaintiffs sued Nationwide, claiming that Nationwide selected fund offerings for a 401(k) plan based in part on the funds' revenue sharing payments. Mr. Sweetnam reported that in denying Nationwide's motion for summary judgment, the court held that Nationwide is a plan fiduciary because it retains discretion to add or delete fund options, that it may have been a fiduciary in selecting funds for its platform, that the revenue sharing payments from the funds might constitute plan assets, and that, even if the revenue sharing payments were not plan assets, Nationwide's receipt of these payments might involve prohibited transactions. Mr. Sweetnam said that there were several other cases in which the plaintiffs argue that revenue sharing payments constitute plan assets. Mr. Kilberg said that the logic required to conclude that revenue sharing payments constitute plan assets would also lead one to conclude that any other compensation received would constitute plan assets, a strange and troubling result. In addition, he noted that district courts seem willing to accept that 401(k) platform providers are fiduciaries, although this is contrary to the industry's understanding.

Mr. Sweetnam commented on several recent settlements with the New York Attorney General. He said that in one such settlement, ING, a 403(b) provider, had agreed, among other things, to a one page, standard disclosure document. He then expressed concern that court decisions and settlements might influence Congress in legislating new disclosure requirements, noting that not all courts are reasonable, and that not all settlements are based on adequate discovery.

Qualified Default Investment Alternatives. Mr. Kilberg reviewed qualified default investment alternatives (QDIAs). He noted that current law (ERISA Section 404(c)) encourages plan fiduciaries to use stable value funds as default investments to minimize the risk of loss (for which a fiduciary may be liable if the participant made no election), even though a stable value fund is unlikely to be the best alternative for a young participant. He reviewed a proposed regulation that would extend the protection from liability that plan sponsors currently enjoy with respect to participant investment elections to QDIAs that are not stable value funds, which should result in improved investment performance for plan participants who use the default investment selection. Under the proposed regulations, to qualify as a QDIA, an investment option must be (i) managed by an ERISA "investment manager" (such as a registered investment adviser) or (ii) a mutual fund registered under the 1940 Act; diversified so as to reduce the risk of large losses; and either (i) a life-cycle fund, (ii) a balanced fund, or (iii) a managed account that is managed to become more conservative over time.

Mr. Kilberg noted that there are a number of issues associated with the proposed regulation. In particular, he noted that under the proposed regulation the plan fiduciary would still be required to ensure that the QDIA is a prudent investment, and to consider the QDIA's fees and expenses. He also noted that a life-style approach involving automatic switching between funds would only qualify as a QDIA if it were a qualifying managed account, and that a model portfolio constructed by a non-investment manager would not qualify as a QDIA. He said that there were challenges associated with selecting a balanced fund as a QDIA, because the plan fiduciary would need to consider what was appropriate for plan participants as a whole, which depends on plan demographics and might change over time. Finally, Mr. Kilberg said that the DOL was being pressured to include stable value funds as possible QDIAs. He noted that this could result in the continued use of stable value funds as the default investment option, thus defeating the purpose of the proposed regulation.

Future Developments. Mr. Healy offered his views on the future of defined contribution plans and predicted significant changes. He predicted that asset allocation funds (especially target date funds) will be the primary investment options, and that the range of investment options will be "pruned." He said that target date funds will come to dominate plan assets, representing 60% of plan assets by 2016. He predicted additional automation in enrollment and contribution escalation, additional disclosure regarding direct and indirect plan payments, and improved disclosure to participants.

These changes, said Mr. Healy, will materially improve results. He cited studies indicating that 401(k) plans, which might ordinarily replace 31% of a participant's pre-retirement income, could replace 47% of pre-retirement income if automatic enrollment and escalation was implemented and 59% if a passive target date fund was the selected investment option. He said that every 1% increase in investment performance over the course of a participant's career could result in an additional 10 years of retirement spending.

General Session: Private Litigation and Regulatory Enforcement Actions

Moderator: Craig S. Tyle, Executive Vice President and General Counsel, Franklin Resources, Inc.

Speakers: James N. Benedict, Chairman, Litigation Department, Milbank, Tweed, Hadley & McCloy
Sarah Bessin, Assistant Chief Counsel, Division of Enforcement, U.S. Securities and Exchange Commission
Katherine Malfa, Vice President and Counsel, NASD
Lori A. Martin, Partner, Wilmer Hale

Private Litigation. Mr. Tyle asked Mr. Benedict to review developments in private litigation involving mutual funds. Mr. Benedict noted that the conference materials included an extensive outline that had been current as of early February, but that in the last seven weeks there had been six new decisions of interest that were not included in the conference materials. These decisions were:

- February 5, In re Evergreen Mutual Funds Fee Litigation, *2007 WL 442158 (S.D.N.Y. 2007)*, before Judge Sweet in the Southern District of New York, where the Court denied the plaintiffs' motion to set aside judgment and affirmed that the plaintiffs' Section 36(b) pleading was insufficient.
- February 22, Fitzgerald v. Citigroup Inc., *2007 WL 582965 (S.D.N.Y. 2007)*, before Judge Batts in the Southern District of New York, where the Court granted the defendants' motion to dismiss, finding that B share information had been fully disclosed, and dismissing 1933 Act and 1934 Act claims.
- February 27, Jones v. Harris Assocs. L.P., *2007 WL 627640 (N.D.Ill. 2007)*, before Judge Kocoras in the Northern District of Illinois (referred to as the Oakmark litigation), where the Court granted summary judgment on Section 36(b) excessive fee claims (applying the standard in Gartenberg v. Merrill Lynch Asset Mgmt., Inc., *694 F.2d 923, 928 (2d Cir.1982)*).
- March 13, In re Franklin Mutual Funds Excessive Fee Litigation, *2007 WL 765690 (D.N.J. 2007)*, before Judge Martini in the District of New Jersey, where the Court granted a motion to dismiss Section 36(b) claims, noting that allegations of high fees and poor performance were not sufficient to state a viable claim.
- March 15, Bellikoff v. Eaton Vance Corp., *2007 WL 766209 (2d Cir. 2007)*, on appeal before the Second Circuit in New York, where, in a per curiam opinion, the Court affirmed the district court's holding rejecting the existence of an implied right of action under the 1940 Act.
- February 26, Siemers v. Wells Fargo & Co., *2007 WL 760750 (N.D.Cal. 2007)*, before Judge Alsup in the Northern District of California, where the Court permitted Rule 10b-5 claims to proceed with respect to revenue sharing allegations (the only one of these recent decisions with an adverse outcome for defendants).

Mr. Benedict noted that the current wave of fee litigation against mutual funds began as a result of three factors: (1) an influential article from 2001 by Professors John Freeman and Stewart Brown entitled "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," *Journal of Corporation Law* 26 609, that suggested that mutual fund advisers were overcharging funds; (2) the market decline in 2001; and (3) New York Attorney General Elliot Spitzer's investigations and enforcement actions. Twelve separate "pure excess fee" suits were filed. The first of the twelve to be set for trial was Baker v. American Century Investment Mgmt., Inc., *No.04-4039-CV-C-ODS, slip op. (W.D. Mo. 2006)*. Mr. Benedict reported that one week before trial the plaintiffs in that case "walked at the altar," dropping their suit and signing a stipulation acknowledging in essence that American Century had not committed the wrongdoing alleged. The next case up for trial is the Janus litigation, set for trial in May. Mr. Benedict said that at least two other cases of the twelve have settled.

Mr. Benedict stated that to date, the current round of fee litigation has not resulted in any adjudicated wins for plaintiffs on the ultimate issues. However, Mr. Benedict said that these cases have shown it is easier to plead a Section 36(b) case and survive a motion to dismiss than in the past. In seven of the twelve cases, defendants' motions to dismiss were denied, and plaintiffs were allowed to proceed with discovery. According to Mr. Benedict, at least some courts are not requiring that plaintiffs plead each of the Gartenberg factors. In other cases, motions to dismiss have been successful. Mr. Benedict reported that while there is a split among courts as to pleading requirements, all courts agree that the Gartenberg factors are the relevant substantive test. Mr. Benedict also discussed standing and damages issues raised by these cases.

Mr. Tyle asked the panel to consider the disclosure requirement imposed by the SEC with respect to board consideration of the relative fees charged for institutional and retail accounts in light of the recent court decisions. Mr. Benedict stated emphatically that the existence of lower cost institutional accounts was not a factor in decided cases. He noted that Gartenberg had already addressed this issue, and Judge Pollack had characterized the differences between institutional and retail fees as akin to comparing "apples and oranges." The Second Circuit had affirmed. Mr. Benedict said, however, that the Freeman and Brown article posed the issue of institutional versus retail fees anew. Attorney General Spitzer revived allegations that retail accounts were being overcharged in relation to institutional accounts. Mr. Benedict reported that in the current round of litigation, the courts have been allowing discovery on the issue, but then finding that retail products required different services and justified different fees.

Mr. Benedict stated that advisers need to make full disclosure to fund boards of the difference between institutional and retail fees *and services*, demonstrating that retail accounts are a bundled product. Mr. Benedict observed that plaintiffs' lawsuits are trying to unbundle retail services.

Mr. Tyle, Mr. Benedict and Ms. Martin discussed profitability numbers presented to boards as part of the contract review process. Ms. Martin observed that some advisers provide fund-by-fund profitability, and that others do not. She noted that profitability was an ill-defined factor. Except for publicly traded advisers that break out their profit numbers, it is usually impossible to know how profitable competitors are. Ms. Martin said that many advisers cite Schuyt v. Rowe Price Prime Reserve Fund, Inc., *663 F.Supp. 962 (S.D.N.Y.), aff'd, 835 F.2d 45, 46 (2d Cir. 1987), cert. denied, 485 U.S. 1034 (1988)*, for the proposition that 77% profitability is not excessive, although that determination was based on the high level of performance and services present. She observed that in general, profitability is most useful when viewed in the context of profitability trends. Increasing profitability may suggest a need for breakpoints or additional services. Mr. Benedict noted that it is difficult to derive profitability; it is an art, not a science. If a firm has high profitability it may only reflect that the firm is more efficient than its competitors. Mr. Tyle noted that the legislative history of the 1940 Act rejected the idea that investment companies were a regulated utility with cost plus profitability.

Mr. Tyle asked about the scope of Section 36(b). Mr. Benedict stated that some controversy exists on this point. He believed that within the Second Circuit, the decision in Eaton Vance, noted above, resolved the issue, limiting Section 36(b) claims to excessive fees, not improper conduct. The issue is more open outside the Second Circuit. Mr. Tyle observed that plaintiffs have alleged that market timing, revenue sharing, failure to participate in class actions and other conduct may also constitute violations of Section 36(b). He noted that Judge Motz, in a 2005 opinion in the Maryland multi-district market timing litigation, allowed discovery to go forward on Section 36(b) claims arising from alleged market timing.

Finally, Mr. Benedict discussed the scope of implied rights of action under the 1940 Act. He noted that the Second Circuit's Eaton Vance decision, building on the reasoning in Olmsted v. Pruco Life Ins. Co. of New Jersey, *283 F.3d 429 (2d Cir. 2002)*, put a further, and perhaps final, nail in the coffin of implied rights of action under the 1940 Act, holding that the only 1940 Act section that permitted an implied right of action was Section 36(b). He predicted that in the future, plaintiffs will look to common law and the 1933 Act and 1934 Act in support of their actions.

SEC Developments. Mr. Tyle asked Ms. Bessin to speak about recent SEC developments.

- BISYS. Ms. Bessin reviewed the facts set forth in the SEC proceeding, In the Matter of BISYS Fund Servs., Inc., *Inv. Co. Act Rel. No. 27500 (Sept. 26, 2006)*. Mr. Tyle asked Ms. Bessin to comment on the distribution aspects of the case. He noted that funds commonly have "no fee" distribution arrangements – *i.e.*, arrangements in which no separate fee is specified for distribution by a service provider who is also providing other services for which a fee is specified. He then asked whether, given that BISYS was the named distributor in the case brought by the SEC, the board should have known that BISYS was engaging in distribution related activities for which it would need to be paid.

  Ms. Bessin agreed that the fund boards knew that BISYS distributed the funds. However, she explained that the SEC was focused on, among other things, certain leading facts in these matters: (1) that the fund boards did not receive all the information they should have; (2) that the advisers had an undisclosed conflict, because BISYS was devoting a portion of its fee to distribution expenses that would otherwise be borne by the adviser; and (3) that the boards did not know the amount of money the advisers were receiving. In reply to a question from Mr. Tyle, Ms. Bessin agreed that the BISYS proceeding was similar to Fitzgerald v. Citigroup, noted above, in focusing on disclosure about payments to service providers to fund boards. She stated that the directors could have signed off on certain of the arrangements detailed in the BISYS proceeding if they had known about them.

- Investment Company Act Section 19(a). Ms. Bessin set forth the facts in the SEC's proceeding against an investment company in Delaware Service Company, Inc., *Inv. Co. Act Rel. No. 27473 (August 31, 2006)*, for failure to send out notices to shareholders required under Section 19(a) of the 1940 Act, disclosing that dividends being paid included a return of capital. Ms. Bessin stated that in the SEC's view, the failure to send out Section 19(a) notices was not a technical violation, but undercut substantive provisions designed to prevent shareholders from a false sense of the performance of their fund. She noted that the industry appeared to have gotten this message.

NASD Developments. Mr. Tyle asked Ms. Malfa to comment on NASD developments. Ms. Malfa stated that the NASD has recently brought gifts and compensation cases, looking at funds as both the receiver and as the giver of improper payments. She reported that in In the Matter of Jeffries & Co, Inc. and Scott Jones, *Securities Exchange Act of 1934 Release No. 54861 (December 1, 2006)*, the NASD named Jefferies and a number of individuals for having provided jet travel, wine, tickets to sporting events and other items of value to mutual fund traders. Ms. Malfa noted that NASD Rule 3060 restricts gifts to a value of $100 per gift, per recipient, per year and that the conduct in this case had been a clear breach of this rule. The SEC brought a companion case alleging that the gifts caused violations of Section 17(e) and other provisions of the 1940 Act and alleging failure to supervise against certain individuals. Ms. Malfa then described the NASD's action against certain Fidelity entities and individuals for receiving gifts from Jefferies.

Ms. Malfa stated that in the wake of their investigation of these matters, the NASD conducted a sweep of over 40 firms of all sizes for similar conduct involving gifts and compensation. The NASD did not find widespread failures, although it noted a lack of supervision, controls and some violative gifts at some firms. Ms. Malfa noted that the NASD sweep report is available on its website (Report on Examination Findings Regarding Gifts and Gratuities, *December 4, 2006*). The NASD also issued Notice to Members 06-69, with additional guidance on the gifts and gratuities rules.

The NASD has also proposed amendments to Rule 3060, which Ms. Malfa described as taking a more "principles based" approach to the regulation of gifts. In response to an audience question, Ms. Malfa stated that the NASD carefully considered whether to raise the $100 limit under Rule 3060, and had concluded not to do so.

Ms. Malfa then reviewed cases against Scudder, Putnam and Alliance Bernstein for violations of Rule 2830, the non-cash compensation rule. She explained that the violations arose from conferences or meetings in which the sponsoring firms combined training or education with other activities. She also noted that the NASD was considering changes in the non-cash compensation rule that would, among other things, prohibit any product-specific contests.

Looking forward, Ms. Malfa said that the NASD will likely bring additional NAV, B share and breakpoint cases. She noted that the SEC has asked the NASD to look at the 600 self-assessments done in response to concerns about these areas to determine if money was returned to customers as required and to test the adequacy of procedures.

Ms. Malfa stated that in the market timing arena, the NASD had turned its attention to improper activities by registered individuals. She noted that the NASD had brought a market timing case alleging that a hedge fund had used improper means to market time various funds, and imposed its largest fine ever against an individual for market timing, a $2.25 million sanction against hedge fund manager Paul Saunders.

NSMIA Pre-emption Cases. Mr. Tyle asked the panel to comment on the scope of authority for state attorneys general to bring cases that impact the regulation of national markets. Mr. Tyle noted that attorneys general in New York, California and Massachusetts have been particularly active in this regard since 2003. Mr. Tyle said that while most firms settled state charges, a small number of firms have resisted the expansion of state regulation. In a pending case in the Southern District of New York filed in 2005, J. & W. Seligman is asserting that the New York Attorney General exceeded its authority in its investigation of the firm. In two separate cases in California, advisers asserted that actions by the California Attorney General against them were pre-empted under NSMIA. Mr. Tyle reported that two lower courts in California upheld the NSMIA pre-emption claims. In January 2007, however, a California appellate court, on a consolidated appeal of the two cases, reversed the lower court holdings (Capital Research and Management Co. v. Brown, *770 Cal.App. 2 Dist., 2007*). Some of the panelists opined that the California decision was not well reasoned, but that it will be controlling in California.

Revenue Sharing Cases. Ms. Martin discussed recent revenue sharing or B share litigation. She noted that plaintiffs in these cases sought to present sales practice cases as prospectus disclosure cases. Ms. Martin explained that the theory in these cases was that had a plaintiff known about revenue sharing (or some other practice), then the plaintiff would not have bought the fund's shares. Ms. Martin noted that several such cases have been dismissed. Mr. Benedict stated that in the last 12 months there have been three such cases in the Southern District of New York with outcomes favorable to defendants, but that the opinion for plaintiffs by Judge Alsup in Siemers v. Wells Fargo & Co., noted above, could not be reconciled with other cases in this area.

Liability for the Proposed Short Form Prospectus. A member of the audience asked what degree of protection the SEC could create by adopting a liability rule governing the proposed short form prospectus. Mr. Benedict and Ms. Martin expressed the view that an SEC rule would have no effect on liability for omissions from a prospectus because prospectus liability derives from statutory requirements under the 1933 Act. Both agreed that the SEC needs to be explicit about incorporation of the SAI and other documents into the proposed short form prospectus. A follow-up question asked whether the SEC could provide by rule that access to disclosure documents (via the web, for example) was equivalent to delivery. Mr. Benedict stated that unless the SEC could guarantee web access, he does not think the SEC could so provide. He believes that in a case brought by a plaintiff that did not have access to the web, the defendant would lose.

Waiver of Attorney Client Privilege. Ms. Bessin was asked the SEC's current views on waiver of attorney client privilege. She noted that the Staff's goal is to get the information it needs, not to get waivers. She said the Staff will work with people to get information without a waiver. In addition, the Staff may be willing to enter into confidentiality agreements. She also stated that the Division of Enforcement has internal policies governing requests for waiver. These policies require that waiver requests be approved at least at the level of an assistant director, and that the Staff explore alternatives to waivers.

Ms. Martin noted that she had a contrary view of the process. Notwithstanding the footnote in the SEC's Seaboard 21(a) Report, *Releases 44969 and 1470 (October 23, 2001)*, she had found that until recently it was the Staff's universal practice to require waivers. She also noted that no courts had accepted the validity of confidentiality agreements. She observed that since the Department of Justice re-formulated its position on waivers in the McNulty Memorandum (Paul J. McNulty, Deputy Attorney General, Principles of Federal Prosecution of Business Organizations, *December 12, 2006*), and after complaints by the American Bar Association, line attorneys have recently ceased always asking for waivers.

Ms. Bessin responded that the SEC had not changed its position. She explained that the Seaboard Report is still the standard for judging cooperation with the Staff. While a waiver will be viewed favorably, Ms. Bessin stated that a refusal to waive the privilege would not be held against someone.

Post-Goldstein Hedge Fund Rule Proposal. Finally, Mr. Tyle asked Ms. Bessin about the Commission's response to Goldstein v. Securities and Exchange Commission, *451 F.3d 873 (D.C. Cir. 2006)*. Ms. Bessin described the SEC's December 2006 rule proposal. She noted that there were situations in which Section 34(b) might be inadequate as a basis to police misrepresentations or improper communications made to shareholders or potential shareholders and that an additional rule was therefore deemed necessary. She also commented that the proposed rule does not include a scienter element.

Panel 1-B: Continuing Evolution of Fund Compliance Programs

Moderator: Francis V. Knox, Jr., Chief Compliance Officer, John Hancock Financial Services, Inc.

Speakers:
Kathie Barr, Chief Compliance Officer and Chief Administrative Officer, Allegiant Funds
Natalie S. Bej, Senior Counsel, Securities Regulation, The Vanguard Group, Inc.
Kathleen Clarke, Counsel, Seward & Kissel LLP
John Walsh, Associate Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission

Mr. Knox began the session by outlining the five topics that the panel intended to address during the session. The topics were: (i) changes to the approach for evaluating and testing compliance programs, (ii) forensic testing, (iii) oversight of sub-advisers and other service providers, (iv) Rule 22c-2, and (v) SEC examinations.

Changes to the Approach for Evaluating and Testing Compliance Programs. Ms. Barr first commented that, at Allegiant Funds, there is now much more organization and documentation relating to compliance testing than in the past and that the compliance group is much more integrated in the business aspects of the firm's meetings than in the past. With regard to the testing, she stated that the compliance group uses a risk based approach, that each year the process of evaluating and testing the compliance program has become more refined, and that the compliance group reviews and modifies the risk matrix as necessary to reflect changes in the business. She commented that this year the group has added more staff to enable forensic testing and has reviewed more service providers. Mr. Knox reported that John Hancock outsourced compliance program testing in the first year and that John Hancock is now testing internally.

A discussion ensued among the panel about the use of other groups and departments within a firm by the compliance group. Ms. Barr commented that the compliance group at Allegiant Funds utilizes the testing of internal audit, but that internal audit is just one resource and it does not replace the compliance department. Ms. Barr also commented that the challenge with testing is to stay focused and targeted and that compliance should focus on the highest risk items. Mr. Knox then commented that in John Hancock's testing, the compliance group works closely with internal audit and with the firm's Sarbanes-Oxley group and that the compliance group also relies on third-party reports with respect to outside service providers.

Mr. Walsh reported that last year, the most commonly reported recommendations by chief compliance officers related to items such as (i) amendments to the firm's policies and procedures, (ii) improvements or updates to the code of ethics, (iii) improvements or updates with respect to the maintenance of books and records, (iv) additional resources to compliance, (v) best execution review/soft dollar policy review, (vi) improvements to disclosure, (vii) business continuity/disaster recovery, (viii) forensic testing, (ix) oversight of service providers, and (x) solicitation agreements. Mr. Walsh also stated that with regard to annual exams: (i) if CCOs have a recommendation to make as a result of the exam, they should make it; (ii) the CCO should revise the risk assessment process to reflect changes in the business; and (iii) the risk assessment process is the foundation for everything else with respect to the exam.

Ms. Bej commented that during the first year following the effective date of Rule 38a-1, her compliance group reported all issues to the board of directors, but that for year two, the group just reported material compliance matters, and worked with the board of directors to determine the factors to consider in determining materiality.

Forensic Testing. Mr. Walsh first commented that firms should use footnote 15 in the adopting release for Rule 38a-1 as a guide for forensic testing. It states in part that "[w]here appropriate, advisers' policies and procedures should employ, among other methods of detection, compliance tests that analyze information over time in order to identify unusual patterns..." Mr. Walsh then commented that with regard to forensic testing, (i) there must be a test, (ii) it must have analysis, (iii) the test must look back over time, and (iv) the compliance group should be looking for patterns.

Ms. Clarke then stated that forensic testing should include tests to determine whether the firm's actions match its policies and the regulatory requirements applicable to the firm. She pointed out areas susceptible to testing such as trade allocation and correlations between sales of fund shares and portfolio brokerage. The panelists then discussed the treatment of false positives that result from testing. It was generally agreed that the CCO needs to show that the compliance group saw the false positives and resolved them. Mr. Walsh pointed out that if a compliance group is seeing a large number of false positives, then the group should reconfigure the filter to narrow the results.

In response to a question, Mr. Knox commented that when a CCO is the chief compliance officer of funds and of the adviser to such funds, the position with the funds should take first priority. Mr. Walsh commented that the rules do not require the CCO of the adviser to be a different person than the CCO of the funds, but that there are inherent conflicts if both positions are held by the same person so the CCO should be mindful of such conflicts.

The panelists then discussed how specific the annual fund compliance report should be, and it was the general consensus among the panel that the report should be very specific. Mr. Walsh commented that Rule 38a-1 was promulgated at least in part to force disclosure to boards of directors.

Finally, Mr. Walsh commented that if something in a firm's business is changing, no matter how mundane, the CCO should be involved.

Oversight of Sub-Advisers and Other Third-Party Service Providers. Ms. Bej commented that her firm has various components to its oversight program and that the compliance group assigns a risk rating to each service provider, which rating determines the depth of review. She stated that the components include (i) a review of the sub-advisers'/service providers' policies and procedures and practices, including any material changes to the policies and procedures, (ii) ongoing communications, (iii) on site inspections (yearly for higher risk managers and every three years for all other service providers) and (iv) certifications and periodic reporting. Mr. Knox then reported that his firm has a similar approach to the Vanguard approach described by Ms. Bej.

Mr. Walsh commented that the SEC wants to know what the CCO is doing with regard to oversight of sub-advisers and third-party service providers. He emphasized that the CCO should take into account a fund's own experience with a service provider. He said that if funds are offshoring service providers, then the SEC will want to know (i) whether the firm is complying with Regulation S-P, (ii) whether the firm knows where its confidential information is going, (iii) what the firm is doing to make sure that its confidential information is kept secure, and (iv) what the CCO is doing to test the firm's security systems.

Rule 22c-2. Ms. Clarke briefly commented that, based on all information that she has, many firms still have work to do to meet the April 16, 2007 deadline for entering into intermediary agreements that comply with Rule 22c-2 under the 1940 Act. Looking beyond April 16th, Ms. Clarke stated that most large intermediaries will be able to provide daily feeds if required by funds and that some fund firms have hired third parties to receive the data feed.

SEC Examinations. Mr. Walsh discussed the SEC's examination process. Mr. Walsh first listed some deficiencies that the SEC commonly identifies. Included in the list were: information disclosures, reporting and filings; governance; personal trading; and information privacy and protection. Mr. Walsh then provided five areas that are currently getting attention from the Staff: proxies, securities lending, undisclosed payments, disaster recovery, and fair valuation.

Mr. Walsh next addressed sweep exams and the enforcement rate (the percent of fund exams that are referred to enforcement). With regard to sweep exams, Mr. Walsh noted that sweep exams are part of the general exam program and that they will continue. With regard to the enforcement rate, Mr. Walsh noted that although standards have stayed the same since 2004, the enforcement rate has declined. Specifically, he noted that in 2004 the enforcement rate was 17% and in 2006 it was between 7 and 8%. Finally, Mr. Walsh briefly commented on four actions that the SEC has brought against compliance officers since 2004: SEC v. Mitchel S.

Guttenberg *(Litigation Release No. 20022, March 2007)*; CapitalWorks Investment Partners, LLC *(IA-2520, June 2006)*; Susana P. Longo *(IA-2445, October 2005)*; and Strong Capital Management, Inc. *(34-49741, IA-2239, and IC-26448, May 2004)*. The misconduct alleged in these actions included insider trading, misappropriation of client funds, misrepresentation of an adviser's disciplinary history, and failure to adequately monitor and address market timing activity by an advisory firm's chairman and chief investment officer.

Panel 2-B: Ethical and Other Challenges Facing In-House Counsel

Moderator:	Kevin M. Carome, Senior Managing Director and General Counsel, AMVESCAP PLC
Speakers:	James R. Bordewick, Jr., Associate General Counsel, Bank of America Corporation Scott C. Goebel, Senior Vice President and Deputy General Counsel, Fidelity Management & Research Company Catherine L. Newell, Vice President, Secretary & General Counsel, Dimensional Fund Advisors Inc. William H. Rheiner, Partner, Ballard Spahr Andrews & Ingersoll, LLP

Mr. Carome opened the presentation by observing that "conflicts are embedded in the very structure of the [mutual fund] industry."

Mr. Rheiner outlined four principles that he suggested could serve as good general guidance to in-house counsel working in asset management firms:

- Know who your client or clients are.
    - Often a lawyer has more then one client in any given situation. For example, a lawyer at an advisory firm may be serving both the firm and the funds it manages.
    - The SEC's Attorney Conduct Rules, adopted under the Sarbanes-Oxley Act, provide some guidance as to who a lawyer's clients may be, at least for purposes of those Rules, but do not necessarily furnish a complete answer in any particular situation.
- Lawyers have the responsibility both to identify and to resolve conflicts.
    - The possibility for conflicts may be especially high in a smaller organization where, because of the limited size of the legal staff, a single lawyer may have obligations to several different entities.
- A lawyer who becomes aware of a breach of fiduciary duty or a violation of applicable law should take action and confront the problem.
- In extraordinary circumstances, a lawyer who becomes aware of a material breach of fiduciary duty or applicable law should consider whether to "report out" the matter to someone outside the client organization (the audit committee or some other committee of the company's or funds' board).

Mr. Carome then offered a number of general observations regarding the relationship of the legal and compliance staffs within asset management firms, and the role of the legal and compliance groups. He noted that there is no single preferred paradigm for the organization of the legal and compliance functions. Different organizations have relied successfully on different structures. Mr. Carome said that his personal preference is for both the legal and the compliance functions to report to the company's general counsel, because it promotes efficiency and helps minimize regulatory risk to the organization (for example, by reducing the likelihood that a matter might "fall between the cracks"). He also observed that, regardless of the organizational relationship between legal and compliance, it is essential that the two groups work well together and that business units do not perceive there to be any opportunity to "forum shop" as between the legal and compliance staffs.

The panel discussed whether a compliance department should be allowed to seek the advice of outside counsel on its own, or should instead refer all legal matters to the in-house legal staff (which would then determine whether outside legal advice should be sought and, if so, from whom).

Mr. Goebel observed that the in-house legal and compliance team often serves as the institutional memory of an organization, in the face of turnover in the senior management ranks of an organization's business units. Mr. Carome said that it is essential that the legal and compliance function have "a seat at the table" when important business decisions are being formulated, and appropriate prominence within the organization. Ideally, he said, the head of the legal and compliance function will report directly to the chief executive officer. If legal and compliance are not regularly in the flow of business information, they may not be able to address effectively the most important legal and compliance issues the organization faces.

Mr. Goebel expressed the view that the adoption of Section 307 of the Sarbanes-Oxley Act, and the SEC's Attorney Conduct Rules thereunder, had not in fact had the adverse effect on in-house counsel's role and effectiveness that some had predicted. Specifically, he said, in his experience, there had not occurred any significant "chilling" of communications between business people and lawyers. He noted that, as adopted, the Attorney Conduct Rules do not include the so-called "noisy withdrawal" provisions that the SEC had originally proposed, under which a lawyer was required, in certain circumstances, to give the SEC written notice of withdrawal from an engagement and to disaffirm the contents of disclosure documents that had been filed with the SEC.

Members of the panel observed that the implementation of Section 302 of the Sarbanes-Oxley Act (requiring the principal executive and financial officers to certify the contents of reports) and of Rule 38a-1 under the 1940 Act (requiring investment companies' chief compliance officers to report material compliance matters to the board) had, as a practical matter, significantly reduced the number of matters that counsel might otherwise have had to consider reporting under the Attorney Conduct Rules. The panel discussed whether, if a matter had already been reported to an investment company's board by the CCO, there would be any obligation on the part of counsel to make a report of the same matter under the Attorney Conduct Rules. The various SEC rules do not provide an express answer to this question, but the panelists seemed to think that such a duplicative report would serve no useful purpose.

Mr. Goebel noted that the Attorney Conduct Rules require that a lawyer who "becomes aware of evidence of a material violation . . . shall report such evidence to the issuer's chief legal officer . . . forthwith." The panel discussed what form such a "report" might take. Mr. Goebel suggested that a hallway conversation would probably not suffice. He said that his firm's compliance procedures require such reports to be made in writing.

The panelists agreed that Section 307 and the Attorney Conduct Rules had not significantly changed the behavior of lawyers in the investment management industry. Mr. Goebel observed, however, that the provisions of the Attorney Conduct Rules that define "representation of an issuer" to include any form of communication with the SEC, or advising an issuer as to the contents of documents that are filed with the SEC, had served to underline the fact that in-house counsel at advisory firms who participate in the preparation of regulatory filings made on behalf of affiliated investment companies may well have an attorney-client relationship with the investment company, in addition to their attorney-client relationship with the investment adviser. He noted that a lawyer who is a party to two such conceptually separate relationships needs to consider carefully what communications may be subject to the lawyer-client privilege, and which client is entitled to the protections of the privilege. For example, he asked, when in-house counsel communicates with the investment company board, is that communication privileged? He said that the answer is not entirely clear, but that, in formulating such communications, he generally assumes that the privilege does not apply, and, therefore, that the communication might be subject to disclosure to regulators or litigants.

Mr. Carome observed that, in general, the attorney-client privilege is not as encompassing as some people apparently believe. He said that, in his view, it is often preferable to resolve close issues in favor of running the business efficiently rather than in favor of preserving the privilege, if the two interests appear to conflict.

Ms. Newell expressed the view that the general counsel's office is often the ethical conscience of an investment management organization, and the guardian of the firm's fiduciary responsibilities. In particular, she said, the general counsel's office must often perform a "gatekeeper" function when the organization is considering new business initiatives. She said that the general counsel's office is responsible for keeping the organization focused on all of the various constituencies to which it owes duties, including clients and, if relevant, affiliated investment companies and their shareholders. She said that the ability of in-house counsel to consult outside counsel who represent separate interests (such as the adviser, the investment companies or the independent directors) free of conflict can often help in sorting out difficult and complex questions.

Mr. Carome said that is it important for lawyers to exhibit an appropriate degree of humility. A hieratical attitude, in which a lawyer tells a client to "just do what I say," will generally not prove constructive. Lawyers should bring common sense to bear, and should also recognize that hard choices will often have to be made, in situations where the law is not entirely clear.

Mr. Rheiner said that moral courage and the ability to make tough choices is essential in a general counsel. He noted that the long-term economic success of an investment management firm depends upon the preservation of the firm's ethics and reputation. Sometimes, he said, short-term financial sacrifice is needed to preserve the firm's reputation, and lawyers are sometimes the persons who need to remind colleagues of this fact. Mr. Goebel observed that the most difficult decisions are those that do not involve a choice between black and white; when a proposed course of conduct is clearly illegal, it is usually not a difficult matter for the lawyer to advise his or her client. Mr. Bordewick said that it is helpful if senior management has established an appropriate ethical tone, so that lawyers do not find themselves in the position of trying to establish and defend such a tone on their own.

Mr. Bordewick then observed that in-house counsel in the mutual fund industry are accustomed to living in a conflict-ridden world. He said that in-house counsel have come to rely on a relatively familiar set of tools for resolving these conflicts, including open discussion of the conflicts with relevant constituencies, anticipating in advance when and where issues may arise, and establishing protocols for dealing with them, and clear delineation of roles and responsibilities for resolving conflicts. He further observed that in-house counsel are accustomed to resolving conflicts in the absence of extensive guidance from the courts and regulators on many of the key issues that frequently arise.

As an example of an issue as to which clear guidance is lacking in the law, the panel discussed the allocation of expenses as between an investment company and its adviser. Ms. Newell noted that the starting point for the analysis is usually the investment management agreement, but that these agreements typically do not answer every expense allocation question that might arise. In the absence of clear guidance in the agreement, counsel might look to such standards as (1) past practice between the parties, (2) industry practice, or (3) in some instances, guidance obtained from the fund board. Mr. Rheiner said that, in his experience, more boards are now receiving periodic written reports detailing the allocation of expenses as between the adviser and the funds it manages. Other recurring issues as to which the panel noted a lack of clear guidance in the law include (1) the allocation of the expenses of a fund merger as between the participating funds, (2) the adequacy of disclosure contained in disclosure documents furnished to shareholders and prospective shareholders, (3) remediation of violations of investment restrictions and guidelines, and (4) whether the adviser has satisfied the standard of care set forth in the investment management agreement or other relevant documents.

The panel noted that, in fund management organizations, in-house counsel typically wears (at least) two "hats" – an adviser counsel "hat" and a fund counsel "hat." The panel discussed whether in-house counsel can ever take off one of these hats, and concern him- or herself solely with the interests of one party. Mr. Goebel said that his own practice is to keep his fund hat on at all times because, over the long term, the adviser's interests are likely to be best served by zealously protecting the adviser's reputation. Mr. Carome agreed that, in the long run, the adviser's and the funds' interests are usually well-aligned. They both agreed that, on matters where the adviser's interests and the funds' are apparently divergent (such as the setting of the fee rates paid by the funds to the adviser), the ability to have recourse to the views of outside counsel who represents only the funds or their independent directors is helpful. Mr. Bordewick noted that adviser employees who are also fund officers may be subject to different standards, in those separate capacities, as regards such matters as indemnification, rights to separate defense counsel and advancement of defense costs. Ms. Newell said that one good solution to the difficulty of wearing multiple hats is to try on each hat sequentially, for purposes of discussion and analysis – that is, to try to consider a matter from the separate perspectives of each of the parties for whose interests one is responsible.

The panelists agreed that, although experienced investment management counsel are accustomed to the challenge of wearing multiple hats and needing to take client interests, as well as adviser interests, into account, younger lawyers, or those who have come to investment management practice from other settings, cannot be expected to be sensitive to these matters without appropriate training.

Mr. Rheiner then summarized several recent SEC enforcement cases that had led to sanctions against in-house counsel in matters relating to the backdating of company stock options. He noted that, in each of these cases, the counsel had personally benefited from the options grants. Thus, the cases involved direct personal enrichment of in-house counsel, rather than the mere giving of legal advice. He also summarized the findings of a 2000 report that analyzed 75 cases in which lawyers had been sanctioned in connection with corporate misconduct. He said that several general conclusions could be drawn from this report:

- Cases brought against lawyers were almost always ancillary to cases brought against the company and/or its senior management; that is, the conduct of the lawyers was seldom the principal focus of the proceeding.
- Most cases against lawyers involved either outright fraud or insider trading (rather than the accuracy of disclosure documents or financial statements).
- Lawyers had a central role in the conduct at issue in most of the cases.
- In cases relating to financial statement disclosure, lawyers had generally ignored clear red flags.
- Lawyers were seldom if ever charged merely for providing bad legal advice; usually they also actively facilitated misconduct on the part of the company or its senior officers.

In response to an audience question, the panel discussed the disagreements that sometimes arise between lawyers and an adviser’s marketing department over the content of prospectuses, sales literature and other marketing documents. Panelists observed that one challenge is for lawyers to understand the investment characteristics of a product or strategy sufficiently to make intelligent comments on the documents that describe them. One panelist remarked that disagreement is less likely to arise over the description of risks than over the description of the opportunities that a strategy or product may present to prospective investors or clients. Mr. Rheiner noted that the process for drafting a mutual fund prospectus is fundamentally different from the process involved in drafting the prospectus for a public offering by an operating company. In the operating company situation, the prospectus is typically produced through a process that involves a large group of lawyers and business principals (including unaffiliated underwriters) sitting together for extended periods of time subjecting every statement in the document to close and careful scrutiny. The process for preparing a mutual fund prospectus typically does not involve such close scrutiny by so many different reviewers, and yet the liability standard that applies is the same as with operating companies.

In response to an audience question, Mr. Carome said that, even if an investment company’s CCO reports organizationally to the investment adviser’s general counsel, it would not be appropriate for the general counsel to dictate the contents of the CCO’s reports to the investment company board.

ROPES & GRAY

Boston
One International Place
Boston, MA 02110-2624
T 617-951-7000
F 617-951-7050

New York
1211 Avenue of the Americas
New York, NY 10036-8704
T 212-596-9000
F 212-596-9090

Palo Alto
525 University Avenue
Suite 300
Palo Alto, CA 94301-1917
T 650-617-4000
F 650-617-4090

San Francisco
One Embarcadero Center
Suite 2200
San Francisco, CA 94111-3627
T 415-315-6300
F 415-315-6350

Washington, DC
One Metro Center
700 12th Street, NW
Suite 900
Washington, DC 20005-3948
T 202-508-4600
F 202-508-4650