2012 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE

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

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General Counsel's Address

Speaker: Karrie McMillan, General Counsel, Investment Company Institute

Ms. McMillan's remarks focused on the potential danger to funds and their investors as a result of regulatory uncertainty and overreach. Ms. McMillan acknowledged that Congress and the American people demanded a vigorous response in the wake of the worst financial crisis since the Great Depression, but warned that certain proposed and recently-enacted regulations failed to clearly differentiate between the services provided by the investment company industry and those provided by other financial industries. Ms. McMillan's remarks focused on the potential dangers posed by the Volcker Rule, reform of money market funds, and recently-enacted amendments by the Commodity Futures Trade Commission (the "CFTC") to Rule 4.5.

Ms. McMillan criticized the application of the Volcker Rule to mutual funds and other investment companies as misdirected. She asserted that although mutual funds were never intended as a target of the rule, the rule was so broadly written that it would treat some U.S. registered funds and virtually all non-U.S. funds as hedge funds and would bar banks from sponsoring or investing in any of these funds. Ms. McMillan warned that the Volcker Rule would sharply reduce liquidity, particularly in the fixed income and derivatives markets, resulting in wider spreads and higher trading costs. She also criticized the Volcker Rule for calling into question a bank's ability to act as an authorized participant for exchange-traded funds. She stated further that the Volcker Rule would prevent U.S.-related global funds from competing with similarly situated foreign-sponsored funds, impede the organization, sponsorship and normal activities of U.S. funds, and limit funds' investment opportunities. However, Ms. McMillan sounded an optimistic note about the potential final form of the Volcker Rule, stating that since Congress had never intended the Volcker Rule to directly affect registered investment companies, she was hopeful that the spillover damage was an "inadvertent side effect" that could be resolved.

Ms. McMillan labeled the potential reform of money market funds by the Securities and Exchange Commission (the "SEC") as "outrageous." She criticized various elements of the SEC's anticipated proposal, including the requirement for firms to set aside capital reserves and the "regulator-imposed freeze on assets." She stated further that allowing the net asset value ("NAV") of money market funds to float would not change investor attitudes and would not prevent redemptions in a crisis or reduce systemic risk. Ms. McMillan touted money market funds as one of the great success stories of modern financial regulation, noting that they have historically functioned under rules that carefully balance the funds' competing objectives of stability of principal, liquidity, and yield. She stated that the 2010 amendments to Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act") made mutual funds more resilient in the face of crisis at a reasonable price. She noted that the 2010 amendments to Rule 2a-7 reduced portfolio risks, increased liquidity, empowered boards to make sure that investors are treated fairly, and made money market funds more transparent. In contrast, Ms. McMillan criticized the latest round of proposed money market reforms, which she said threaten to drive investors away from money market funds into unregistered cash products that have no risk-limiting regulations, no required liquidity, no board governance and no transparency.

Ms. McMillan criticized recently-enacted amendments to Rule 4.5 as either expanding the CFTC's jurisdiction or driving mutual funds out of the markets for futures, options, and swaps, noting that either result would be detrimental to investors. She asserted that the CFTC had set out to target a small number of "futures-only investment products" that were evading CFTC regulation, and instead produced a rule that sweeps in thousands of equity, bond and hybrid mutual funds and unnecessarily subjects them to a new regulator. She also criticized the CFTC's amendments as premature, given that the rules for swaps trading under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") remain unsettled.

Ms. McMillan expressed doubt that these regulatory initiatives could be justified by a rigorous cost-benefit analysis or would be beneficial to investors. She expressed her hope that the industry's resistance to these initiatives would lead to reconsideration of each of the proposals.

Keynote Address

Speaker: Elisse B. Walter, Commissioner, U.S. Securities and Exchange Commission

Commissioner Walter urged the money market fund industry to end its "unconstructive disengagement" regarding money market reform and to reopen a constructive dialogue with the SEC. She stressed that money market funds are too important to "let the dialogue play out through a public volley of slogans," noting that she has always viewed the engagement of the industry with the SEC as essential to reaching optimal answers regarding securities regulation. Commissioner Walter stated that she had not formulated a definitive position regarding money market reform and intended to continue to discuss critical questions.

Commissioner Walter discussed the history of money market reform and commented on the growth of money market funds. She highlighted the important role money market funds now play in capital markets and noted that institutions hold nearly two-thirds of money market fund assets. Commissioner Walter stated that, while the 2010 amendments to Rule 2a-7 strengthened the risk-limiting provisions of the rule, they were intended to be only the first step in addressing the vulnerability of money market funds to breaking a buck and the susceptibility of prime funds to mass redemptions. She stressed the importance of remembering the 2008 financial crisis and the relationship of money market funds to systemic risk, noting that, in her view, not enough has been done.

Commissioner Walter acknowledged that the money market fund industry has had a strong record of stability but observed that it has been dependent on fund managers stepping in from time-to-time to bail out funds by buying distressed securities. She noted that between 2007 and 2008, nearly 20% of money market funds received support from managers or their affiliates. She cautioned that money market funds cannot always depend on a well-funded sponsor and that the federal government no longer has the authority to stop runs on money market funds that it did in 2008 and 2009 with its guarantee programs. It is for this reason, she said, that the President's Working Group recommended that money market funds be required to internalize fully the costs of liquidity and other risks associated with their operations.

Commissioner Walter acknowledged that there are risks to moving ahead with additional reforms, especially at a time of low yields. She stated, however, that there was also significant risk in not acting. Commissioner Walter concluded by identifying a variety of proposals that are currently under consideration by the SEC and invited the money market fund industry to engage with her and her colleagues to work toward a solution.

<u>General Session – Looking Forward: Where Will the Asset Management Business be in 10 Years?</u>

Moderator: Brian Reid, Chief Economist, Investment Company Institute

Speakers: John E. Baumgardner, Jr., Partner, Sullivan & Cromwell LLP
Marie A. Chandoha, President and CEO, Charles Schwab Investment Management, Inc.
Avi Nachmany, Executive Vice President and Director of Research, Strategic Insight
J. Alan Reid, Jr., CEO, Forward

This panel addressed current trends in the mutual fund industry and expectations for the future. Mr. Brian Reid reviewed a series of slides depicting trends in assets under management across the industry, noting in particular the recent rapid growth of exchange-traded funds ("ETFs"), the flattening of ownership of traditional mutual funds and equity securities, and a steady decline in the number of equity funds with net inflows. He commented that these trends reflected a decline in risk tolerance among all age groups, but in particular among older investors in 401(k) accounts.

Mr. Nachmany commented that it was reasonable to expect a return to a more normalized interest rate environment over the next five years, which would have significant implications for the value of investors' fixed income portfolios. He said that the risk embedded in fixed income products is higher than at any other point in recent history and that recent historical returns of these products could lead to unrealistic expectations among investors. Mr. Baumgardner agreed with this assessment and suggested that managing investor expectations in this regard represented a major challenge for the industry. Ms. Chandoha commented that this environment created the opportunity for the industry to respond with innovative products designed to meet the demand for greater downside protection.

Mr. J. Alan Reid discussed demographic factors that were leading greater numbers of investors to seek professional advice or, alternatively, products that embedded advice by being tailored for investors with specific individual needs. Ms. Chandoha suggested that some products – *e.g.*, ETFs and index funds bundled with some element of advice – would likely be cheaper than traditional fund products sold in the intermediary channel.

The panelists noted that the growing role of financial advisors appeared to be leading to shorter holding periods, which would tend to increase the cost of doing business for fund sponsors. It was suggested that the proliferation of alternative investment options had tended to reduce investor focus on mutual funds as a distinct product category. Ms. Chandoha suggested that pending Department of Labor ("DOL") rulemaking efforts would increase transparency of costs and lead to greater cost competition among fund sponsors. Mr. Nachmany suggested that investors' more direct involvement in the experience of "Main Street" had caused perceptions to lag the actual rebound in the equity markets, and that attitudes toward the mutual fund industry would improve as investor perceptions caught up with recent market performance.

The panelists concluded by offering their predictions for the next decade. These included the following: concerns about the current "frenzy" of legislation and regulation touching the industry, the importance of product innovation, the challenges presented by the use of certain alternative products within the 1940 structure, and the challenges of leveraging these products for offering outside the U.S.

General Session: Regulatory Developments at the SEC and CFTC

Moderator: Karrie McMillan, General Counsel, Investment Company Institute

Speakers: Andrew J. Donohue, Partner, Morgan Lewis & Bockius LLP
Michael J. Downer, Senior Vice President, Capital Research and Management Company
Kathryn L. Quirk, Chief Legal Officer, Prudential Investments
Eileen Rominger, Director, Division of Investment Management, U.S. Securities and Exchange Commission

CFTC Rule 4.5 Adoption and Harmonization Proposal. Ms. Quirk summarized the CFTC Rule 4.5 rulemaking events to-date and then reviewed the revised Rule 4.5 tests (initial margin for speculative trading, net notional value for speculative trading, and marketing tests). Ms. Quirk noted that the carve-out for bona fide hedging may ultimately not be helpful to registrants due to how narrowly bona fide hedging is defined. In response to several questions relating to the issue of overlapping SEC and CFTC regulations, Ms. Rominger reported that the staff of the Division of Investment Management has been meeting with the staff of the CFTC to share information and discuss potential issues, and that the SEC staff is examining the practical effects of the CFTC rules on the SEC framework and disclosure. Ms. Quirk then summarized the harmonization of disclosure issues, including requirements relating to disclosure delivery, disclosure of performance information, fee disclosure, prospectus updating, and recordkeeping. In response to a question, Ms. Rominger reported that there are no current plans for the SEC to issue a companion release to the recent CFTC release, and she encouraged the mutual fund industry to engage with the CFTC on the mutual fund industry's perspectives on harmonization issues.

Derivatives Concept Release. Mr. Donohue summarized the history of regulations relating to the use of derivatives by mutual funds and noted that the current rules are "blunt tools" for regulating derivates. He then reviewed the issues raised by the concept release issued by the SEC in August 2011 on the existing regulatory framework governing the use of derivatives by mutual funds. Mr. Donohue noted that the Investment Company Institute ("ICI") derivatives roundtable, *2012 Derivatives Roundtable: Exploring the Use of Derivatives by Mutual Funds, Closed End Funds and ETFs*, was a good first step in addressing these issues. Ms. Rominger noted that the concept release called out many, but not all, issues with derivatives use. Ms. Rominger reported that the SEC staff is still analyzing the responses and results of the roundtable and looks forward to further engagement with the mutual fund industry on the topic of derivatives regulation. In response to a question, Ms. Rominger stated that a roundtable discussion is a useful vehicle but it needs a great deal of focus to get substantive input, and confirmed that there are no current plans for a more formal roundtable in the near future.

SEC Initiative Regarding Effectiveness. Ms. Rominger discussed an initiative to improve effectiveness at the SEC, (i) institutionalizing interaction among the Office of Compliance Inspections and Examinations, the Enforcement Division, and the Division of Investment Management, including regular periodic meetings; (ii) improving transparency and responsiveness in the way the Investment Management staff interacts with registrants, especially in the exemptive relief process; and (iii) improving the use of information technology within the SEC.

ETF Exemptive Application Moratorium. In response to several questions, Ms. Rominger reported that she expects much of the work with respect to derivatives referenced previously in the panel will need to be completed before the SEC staff is prepared to lift the moratorium on exemptive applications relating to ETFs utilizing derivatives. She also noted that, although the case for codifying ETF exemptive relief is powerful, she did not believe that codification would occur in the near future due to resource constraints.

Rule 12b-1 Reform, Investment Adviser/Broker-Dealer "Fiduciary Duty" Proposal, and Shareholder Report Reform. In connection with her discussion of Rule 12b-1 reform, Ms. Rominger stated that cost-benefit analyses are fully integrated into policy initiatives, that the SEC is devoting resources to cost-benefit analyses, and that the Division of Investment Management is hiring two additional cost-benefit analysts. In response to questions about the SEC's investment adviser/broker-dealer "fiduciary duty" proposal, Ms. Rominger noted that the Division of Investment Management staff is working with the Division of Risk, Strategy and Financial Innovation and the Division of Trading and Markets to ensure that the rule is informed by good data. She said that the SEC intends to request comments and data on possible costs of taking action in this area. In connection with the discussion on shareholder report reform, Ms. Rominger noted that this is an area where the SEC can benefit from surveying shareholders regarding what portions of shareholder reports they find helpful. She also noted that the staff will need to parse through recently-received data in order to determine what it will recommend to the SEC.

Workshop 1-A: State of the Money Market Fund Industry

Moderator: Jane Heinrichs, Senior Associate Counsel, Investment Company Institute

Speakers: Paul S. Atkins, CEO, Patomak Global Partners, LLC
Stephen A. Keen, Reed Smith, LLP
Simon Mendelson, Global Co-Head, Cash and Securities Lending, BlackRock Financial Management L.P.
Robert E. Plaze, Division of Investment Management, U.S. Securities and Exchange Commission
Lloyd A. Wennlund, Executive Vice President and Managing Director, Northern Trust Global Investments

Current State of the Money Market Fund Industry. Ms. Heinrichs opened the workshop by discussing the resiliency of money market funds over recent periods. She noted that approximately the same amount of assets were invested in money market funds in 2011 as in pre-crisis 2007, notwithstanding the drastically lower yields currently paid by money market funds. Ms. Heinrichs reported that the ICI had studied changes in the mark-to-market net asset values of money market funds ("shadow NAV") during the height of the European bank crisis and found that, on average, the shadow NAV declined only $0.00009 per share.

Ms. Heinrichs described a review of the industry that indicated advisers now manage money market funds more conservatively. She reported that, as compared with pre-crisis investments, money market funds now invest significantly more in repurchase agreements and treasuries and less in commercial paper. She noted that not all of the changes in management could be attributed to the 2010 amendments to Rule 2a-7 under the 1940 Act. She stated, for example, that the study indicated funds generally maintain measures of liquidity (*e.g.*, weighted average life) that significantly exceed the enhanced requirements of Rule 2a-7.

Mr. Plaze stated that he considers a money market fund's yield relative to industry averages as a means of identifying funds with greater risk. Mr. Plaze said he worries about the incentives for managers to reach for yield in the current low interest rate environment, where many managers are waiving significant amounts of their fees, and that, in his view, these outlying funds are the most likely source of future risk contagion for the money market fund industry as a whole. He stated that, although Rule 2a-7's requirements are significant, flexibility in complying with Rule 2a-7 has led to a money market fund industry with funds spread across a relatively wide spectrum of risk. He identified the "time of purchase" tests in Rule 2a-7 as a source of weakness because money market funds with troubled securities in their portfolios tend to sell the highest quality securities first to meet redemptions, leaving troubled securities to represent a greater percentage of the fund's remaining portfolio. Mr. Plaze also stated that he continues to believe institutional investors will be quick to redeem from a money market fund that is showing any signs of trouble, and that the use of amortized cost generally means the remaining investors bear any losses that result.

Mr. Mendelson stated that he believed the 2010 amendments to Rule 2a-7 codified prudent management practices that his firm and many others employed even before 2010. In response to a question, he cited headline risk, or the risk of negative reports or publicity, as a significant current risk to money market funds. Mr. Wennlund also stated his belief that money market investors now take a more sophisticated approach to investing, including relying on the wider amount of information available (*e.g.*, the financial stability of a fund's sponsor and the reported mark-to-market value), and no longer look just to yield.

Views on Future Money Market Reform. Ms. Heinrichs argued that requiring money market funds to "float" their NAV would have little to no effect on investor perceptions because money market funds' shadow NAVs rarely move enough to require them to price their shares at anything other than $1. She noted that money market funds would have to have a price of $1,000 per share or greater in order for typical variations in market value to cause a money market fund's share prices to fluctuate at all.

Mr. Atkins criticized a number of arguments in support of further money market fund reform. He argued that money market funds do not represent a "shadow" banking system as they operate without deposit insurance, sell their securities in the registered world, and report significant financial information publicly. He stated that, in his view, money market funds take prudent risks and, unlike banks, are not highly leveraged. Mr. Atkins suggested that the 2008 crisis had been over-emphasized as a historical precedent and that the SEC needs to complete more cost-benefit analysis with respect to the proposals reportedly under consideration.

Mr. Plaze encouraged the audience to review the President's Working Group's report. He said he found the report thoughtful and instructive, especially as to the cost-benefit analysis of various proposals. In response to a question as to whether the SEC intends to conduct investor outreach regarding a potential proposal that would require money market funds to float their NAVs, Mr. Plaze said he would stipulate that investors will not like the idea. He stated, however, that the long-term stability and viability of the short-term markets and removing implicit government support of money market funds were more important considerations. Mr. Mendelson noted that his firm believes that pockets of investors could tolerate a floating NAV, assuming that tax relief in respect of the potentially modest gains and losses were included in the reform package. He also said that he thought government money market funds should continue to use the amortized cost method to value their investments, regardless of what happens to the rest of the money market fund industry.

Mr. Keen discussed the possible form that capital buffer solutions might take. Mr. Keen noted that the ramifications of a fund's inability to meet the capital requirements were unclear under the proposals under consideration, for example, whether the regulations require such a fund to cease accepting new subscriptions or liquidate. During the discussion, Mr. Plaze acknowledged that many parties believe the cost of capital for such a program, which would be passed on to shareholders in some form, may be too high to allow the funds to continue to be attractive investment options, especially in the current interest rate environment.

Workshop 1-B: Current Tax Developments

Moderator: Keith Lawson, Senior Counsel, Investment Company Institute

Speakers: Shawn K. Baker, Traditional Funds Tax Leader, PricewaterhouseCoopers LLP
Ronald A. Dabrowski, Deputy Associate Chief Counsel (International), Internal Revenue Service
Julie C. Henderson, Vice President and Controller, Dimensional Fund Advisors LLP
Monette R. Nickels, Senior Vice President, Director of Tax, ALPS Fund Services, Inc.

Foreign Account Tax Compliance Act ("FATCA"). Mr. Lawson reviewed the purposes of FATCA which, in the most general terms, is designed to ensure that wealthy U.S. persons holding assets through offshore entities and overseas accounts pay any U.S. taxes on income generated from those entities or accounts, and to force foreign financial institutions ("FFIs") to help identify such persons. As a result, FATCA generally requires FFIs that hold U.S. investments to: (i) enter into agreements ("FFI Agreements") with the Internal Revenue Service ("IRS"); (ii) identify U.S. taxpayers (whether direct or indirect account holders); (iii) report to the IRS on those taxpayers; and (iv) withhold 30 percent on certain payments to so-called "recalcitrant account holders" and FFIs that do not meet FATCA requirements.

The IRS issued proposed regulations under FATCA on February 8, 2012 (the "Proposed Regulations"), and on the same day issued a Joint Statement by and among the United States, France, Germany, Italy, Spain and the United Kingdom, outlining a possible alternative intergovernmental approach to implement FATCA's objectives without creating local-law conflicts (the "Joint Statement"). Mr. Dabrowski stated that the IRS will issue additional guidance in the form of a draft FFI Agreement in the spring of 2012 and final FATCA regulations in summer or fall of 2012.

Mr. Lawson stated that, under the Proposed Regulations, the FATCA reporting and withholding rules have been relaxed to some extent. Reporting still commences for the calendar year 2013, but will be implemented gradually over a three-year period. The Proposed Regulations also effect a one-year delay – until January 1, 2014 – for withholding on U.S.-source "ordinary" income (*e.g.*, dividends and interest), a two-year delay – until January 1, 2015 – for withholding on gross proceeds from sales of property capable of producing U.S.-source dividend or interest, and a four-year delay – until January 1, 2017 – for withholding on so-called "foreign pass-through payments."

Mr. Lawson pointed out that it is important to understand that FATCA's withholding system is the only – albeit significant – "stick" to effectively force the FFIs to comply with the reporting rules; the revenue estimates associated with FATCA relate not to any expectation that the withholding provisions will actually kick in – that is not the intention – but rather to improved compliance and taxes paid by U.S. persons.

Mr. Lawson also reported that, partly in response to concerns raised by small institutions and others that local-country laws prevented them from disclosing the information sought by the IRS from FFIs, the Proposed Regulations adopt a concept of "deemed compliance" in respect of two types of FFIs, which are therefore not required to enter into an FFI Agreement to avoid FATCA withholding: "registered deemed-compliant FFIs" and "certified deemed-compliant FFIs." He noted that these deemed compliant entities – generally including, among others, certain foreign funds, retirement plans, and non-profit organizations – nevertheless must meet certain other less onerous requirements under the Proposed Regulations.

The panelists then discussed the Joint Statement. As Mr. Lawson reported, although, in its narrowest sense, the Joint Statement addresses a concern about data privacy, it reflects a number of principles that will potentially help streamline or supplant the FATCA process. In light of FATCA's objectives, the U.S.'s willingness to reciprocate in collecting and exchanging information on accounts held in U.S. financial institutions by residents of the participating countries, and certain other considerations, the Joint Statement indicates that the six participating governments have agreed to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic information exchange based on existing bilateral tax treaties. Mr. Lawson stated that the Joint Statement also more generally represents an intergovernmental approach to improving international tax compliance, and presents a possible framework for obtaining its objectives.

Mr. Lawson stated that the Joint Statement is noteworthy for a few reasons. In particular, it would permit certain non-U.S. entities located in a participating jurisdiction to comply with the requirements of FATCA without violating local laws. Also, if successful, it will potentially enable the U.S. government to avoid imposing a burdensome foreign passthrough payments system. At the same time, he noted that the U.S.'s stated commitment to reciprocity potentially means that U.S. withholding agents may become subject to additional reporting obligations on payments to non-U.S. persons.

Treaty Developments, Including Establishing Eligibility for Benefits. Ms. Henderson first observed that international tax issues have become an increasing challenge to asset managers, including the sheer administrative burden of keeping up with all of the different tax systems, stemming from a combination of increased reporting requirements, higher tax rates overall, increased imposition of capital gains tax withholding, requests for additional documentation, and aggressive enforcement efforts to ensure compliance. She then reviewed a number of developments relating to increased withholding rates in certain markets in each of Belgium, France, Japan, Portugal, Spain, and South Africa, and noted that countries are stepping up their documentation requirements in an effort to determine eligibility for treaty benefits, including in cases where investors come in through funds, potentially including regulated investment companies ("RICs"). For example, Germany now requires "applicable transparency declarations" as to the percentage of underlying investors eligible and shares outstanding at each ex-date of a dividend event. She noted that, as of January 1, 2013, Canada will require similar fund declarations and that Austria is currently clarifying its requirements relating to such documentation. Ms. Henderson commented that service levels are different among global custodians, which may affect the willingness with which, or the manner in which, they file for treaty benefits if not all investors are eligible for treaty benefits.

Ms. Henderson then discussed the difficult accounting issues presented by local taxes potentially imposed by countries that are of uncertain application. Mr. Baker pointed out that the U.S.'s large treaty network mitigates the instances in which this question comes up, but that where it does, for example in many emerging market countries, it is not entirely clear what constitutes the type of "administrative practice" that forms the basis for not accruing a tax.

Reclaims of Tax Under European Union (EU) Article 56. Ms. Henderson reported recent favorable decisions regarding claims that withholding taxes on dividends have been imposed on a discriminatory basis as they are not imposed on the withholding country's own residents. She stated that these claims potentially involve billions of dollars for U.S. RICs (with estimates as high as $15 billion).

- <u>Netherlands</u> – A board of appeals found that entities resident in qualifying third countries exempt from profits tax in their home country were eligible for a full refund of Dutch withholding tax to the extent relating to portfolio dividends (effective January 1, 2012).
- <u>France</u> – Test case was referred to the European Court of Justice ("ECJ") by the French Supreme Tax Court. The ECJ heard the case in February and is expected to render a decision by mid-April.
- <u>Germany</u> – The ECJ rendered a final decision relating to corporations not fulfilling the requirements of the parent-subsidiary directive ("PSD") to be entitled to the withholding tax refund under the PSD.

If and when significant EU reclaims are in fact recovered, they will implicate foreign tax credits that RICs have previously passed through to their shareholders. Mr. Dabrowski indicated a willingness on the IRS's part to work with the industry to reach reasonable administrative settlements.

PFIC Update. Ms. Henderson reviewed some issues receiving recent attention, including the fact that certain issuers that are incorporated off-shore (such as in Bermuda or the British Virgin Islands) may constitute passive foreign investment companies ("PFICs") notwithstanding that their securities are traded on U.S. exchanges. Separately, there are continuing difficulties with PFIC identification, generating so-called "late identified PFICs" creating potential entity-level inclusions over a period of years. Finally, increased shareholder demand for qualifying electing fund ("QEF") elections is creating additional costs and complexity for offshore products with U.S. investors.

Alternative Investment Strategies. Ms. Nickels discussed the IRS's "pause" in respect of rulings relating to indirect investments in commodities, for example through commodity-linked notes ("CLNs") or controlled foreign corporation ("CFC") subsidiaries. She noted that recent

Congressional hearings by the Permanent Subcommittee on Investigations entitled "Compliance with Tax Limits on Mutual Fund Commodity Speculation" have further turned up the heat a bit. Ms. Nickels observed that there has still been no official notice that undermines the reasoning behind scores of rulings previously issued. Mr. Baker noted a number of formalities a CFC is advised to observe so as to ensure that it will be respected for tax purposes.

She further observed that a number of RICs have been investing in other real assets through master limited partnerships ("MLPs") qualifying as so-called qualified publicly traded partnerships ("QPTPs"). Such QPTP investments are limited to 25% of a fund's total assets and are further limited in respect of the percentage interest any RIC can make in a particular QPTP. Such MLP investments raise significant tax issues, including for example state income tax exposure arising from partnership allocations reflected in Schedule K-1s that such MLPs are required to provide to their interest holders (partners), including RICs.

Mr. Baker reviewed certain significant federal income tax issues presented by RICs investing in unregistered hedge funds. He noted that such arrangements are appealing, among other reasons, because they provide 1099 Forms to their investors rather than Forms K-1. He noted that such funds can be set up as either open-end or closed-end funds, but are frequently better suited to closed-end form because of the liquidity limitations typically associated with hedge funds. He stated that RIC investments in hedge funds taxed as partnerships potentially raise qualifying income and qualifying asset (diversification) issues; he explained that RICs frequently make such investments through offshore funds constituting PFICs for tax purposes when adequate information is not available from the hedge funds.

RIC Modernization Implementation Considerations. Mr. Baker reviewed the most favorable aspects of RIC Modernization, including cures now available in respect of violations of both the gross income test and asset diversification test and the significantly changed treatment of capital loss carryforwards. He noted that, in connection with the latter, the industry is requesting a technical correction to clarify the impact of the new capital loss carryforward rules on the excise regime. Mr. Baker then discussed certain technical issues associated with some of the new excise tax rules, including the new rules (i) providing more flexibility but frequently reduced tax efficiency with respect to post-October capital losses, and (ii) relating to late-year (ordinary) losses (including both post-October "specified losses" and post-December "other ordinary losses"). Finally, he mentioned that the new earnings and profits rules can create technical difficulties for non-calendar year global bond funds in terms of their impact on prior distributions.

Workshop 1-C: 401(k) Regulation at the Crossroads

Moderator: Elena Barone Chism, Associate Counsel, Investment Company Institute

Speakers: Jon W. Breyfogle, Principal, Groom Law Group
Robert A. Holcomb, Executive Director, J.P. Morgan Retirement Plan Services LLC
Douglas O. Kant, Senior Vice President and Deputy General Counsel, Fidelity Investments

Lifetime Income from Retirement Plans. Ms. Chism said that, in light of the aging baby boomer generation and the decline of defined benefit retirement plans, Congress was focused on whether defined contribution retirement plans were adequate in providing for retirement income. Mr. Kant said that in 2010 the IRS/Treasury issued a joint request for information, driven by concerns about the shift in the private sector from defined benefit retirement plans to defined contribution retirement plans, as well as the increasing offer and acceptance of lump sums from defined benefit plans upon retirement. He said that recent guidance (REG-115809-11) proposed an exception to the minimum required distributions for qualified longevity annuity contracts ("QLACs") so that distributions could be smaller in the early years of retirement (thus increasing the likelihood that retirement income would be available for a longer period of time). He said that there was also a proposed regulation (REG-110980-10) permitting partial annuities in defined benefit plans, so that retirees need not make an all-or-nothing lump sum decision. Mr. Kant characterized these changes as useful but not "game changing."

Mr. Kant said that, in an effort to improve participants' understanding of their expected retirement income, the DOL was expected to introduce regulations in mid-2012 requiring illustrations of lifetime income streams for retirement accounts. He noted that the DOL would have to consider whether these illustrations would be based on current or projected account balances and the appropriate method for converting account balances into estimated income streams.

New Disclosures to Plan Fiduciaries. Mr. Kant reviewed the required disclosures that covered service providers must make to plan fiduciaries to comply with the final rule under Section 408(b)(2). (The final rule (1.408(b)-2(c)) was released on February 3, 2012 and becomes effective on July 1, 2012). He noted that failure to make the necessary disclosures would render the service provider arrangement a prohibited transaction. He said that the final rule applies to Employee Retirement Income Security Act ("ERISA) covered defined benefit and defined contribution pension plans (and not simplified employee pension plans ("SEPs") or individual retirement accounts ("IRAs"), and commented on the definition of covered service providers under the rule. He noted that record-keepers and brokers have the most burdensome disclosure requirements, and must make a good faith estimate of the compensation for record-keeping services in bundled arrangements. Mr. Kant said that there was no required format for providing the necessary disclosure, but that the DOL may publish a summary form for the required disclosure in the future.

Mr. Kant said that the final rule allows for timely corrections of errors or omissions in required disclosure. The service provider must be acting in good faith and with reasonable diligence, and it must make the corrections within 30 days of becoming aware of the error or omission. The final rule also requires plan fiduciaries to report to the DOL if any covered service providers do not deliver the required disclosures, which may prompt the DOL to follow up with service providers.

New Disclosures to Plan Participants. Mr. Holcomb said that, by August 30, 2012, the following additional information must be provided to participants in participant-directed plans: (1) general information about the plan, which must be provided before the participant invests and annually afterwards; (2) quarterly information about the plan's administrative expenses; (3) quarterly information about the individual participant's expenses; and (4) investment-related information. In general, he said, the industry already provides the first three categories of information. The investment-related information would take the form of an annual comparison chart, providing performance information (for one-, five-, and ten-year periods or the life of the investment if shorter) for designated investment alternatives, together with comparable information for an appropriate broad-based market index. In addition, the chart would include fee information and an expense example based on a $1,000 investment. Ms. Chism said that it was not clear whether a managed account was a designated investment alternative for purposes of this disclosure rule; if it is, she said, it is not clear how to present information about the managed account in the comparison chart.

Electronic Disclosure. Mr. Holcomb reviewed the current guidance on electronic disclosure. He said that a 2002 DOL rule (29 CFR 2520.104b-1(c)) required affirmative consent to the receipt of materials electronically. He said that this rule was relaxed in 2006 (FAB 2006-03) to allow participant statements to be sent electronically, provided that participants had the ability to opt out of electronic delivery. He said that interim guidance (Technical Release 2011-03) with respect to the investment-related comparison chart offered only limited relief – the chart may be sent electronically only to participants who have used an e-mail address to communicate with the plan in the past year, and it will be necessary to confirm this on an annual basis.

Proposed Expansion of Fiduciary Definition. Mr. Breyfogle said that ERISA regulates "fiduciaries" to retirement plans, that "fiduciary" includes a person providing "investment advice," and that the DOL proposed regulations in 2010 (75 CFR 65263) that expanded the scope of "investment advice." He said that the proposed regulations provided that advice need not be "regular" or the "primary basis" for any decision. He said that this proposed change raised questions about whether sales pitches, sample plan line-ups, recommending investment managers, providing customer service advice regarding rollovers, or providing valuations, constituted investment advice. Following outcry from the industry, Mr. Breyfogle said, the DOL retracted the proposed regulations. He said that the DOL was expected to re-propose the regulations in 2012.

Legislative Outlook. Mr. Breyfogle said that the tax preference afforded to retirement plans was estimated to represent over $800 billion in foregone tax revenue over the next five years. He said that in the current deficit environment, this tax preference would inevitably be considered at some point in the legislative process. He noted that President Obama's recent budget proposal would limit the tax benefit for high income persons.

Workshop 1-D: European Fund Regulatory Developments: What's on the Horizon

Moderator: Dan Waters, Managing Director, ICI Global

Speakers: Jon E. Boustany, Deputy General Counsel, Legg Mason, Inc.
Claude Kremer, President, EFAMA
Kevin Ouellette, Senior Counsel, Wells Fargo & Company
Nick Williams, Partner, Allen & Overy LLP

The panel discussed recent developments in European regulation of the financial services industry and sought to provide context for a wide range of changes in the regulatory landscape.

European Regulatory Developments. Mr. Williams discussed a large number of European regulatory developments that are currently underway, noting that a massive volume remains to be completed. His observations on specific regulations and initiatives included the following: (a) the fourth EU Directive on Undertakings for Collective Investment in Transferable Securities ("UCITS IV") is nearing implementation, with the use of the Key Investor Information Document (the "KIID") to be required by June 30, 2012; (b) recent interpretive papers have been produced on the European Market Infrastructure Regulations ("EMIR"), which would regulate European derivatives markets, though Mr. Williams noted that the stated goal of implementation by the end of 2012 appeared optimistic; (c) the Alternative Investment Fund Managers Directive ("AIFMD") is moving to more detailed (Level 2) procedures; (d) Solvency II is a new prudential regime governing insurance companies that will become binding in 2014, and is expected to have significant influence on what insurance-related products are created and how they are disclosed by insurance companies; (e) the proposal previously referred to as the Market Abuse Directive ("MAD") is being transitioned from a directive to a regulation ("MAR"), which will result its immediate implementation upon completion; and (f) the changes in the Markets in Financial Instruments Directive ("MiFID II") are expected to be finalized, together with new related regulations ("MiFIR"), by the end of 2012.

Mr. Williams highlighted trends in the European lawmaking and regulatory process. Of particular importance is the use of "binding technical standards" by the European Securities Markets Authority ("ESMA"), which creates a broad power to impose its standards across Europe. A second trend toward consistency is the effort to create a "single rulebook" of Europe-wide standards, with ESMA and other European Supervisory Authorities ("ESAs") helping to mediate across borders; though national variations may persist because the implementation of standards will be completed at the member-state level. Third, Mr. Williams described an increased willingness on the part of European regulators to intervene in the creation of investment products that they deem not to be safe or appropriate for the intended market. The panel discussed these trends toward harmonizing markets and products – which Mr. Waters dubbed as evidencing a "Cartesian approach to regulation" – and observed that increased consistency across Europe should increase the ability of U.S. asset managers to build scale for their product offerings in Europe and more broadly on the global market.

Cross-Border Delegation. Mr. Williams observed that the cross-border delegation rules are central to the ability of U.S. managers to offer services in European countries, and he described outsourcing as picking up traditional sub-advisory relationships as well as other service provider relationships. He noted that UCITS, AIFMD, and MiFID II all potentially impact the environment for delegation. Under MiFID II, an asset manager will only be able to service retail European clients if it establishes a branch in Europe and registers with ESMA, and if the manager's home country maintains a reciprocal relationship with the European jurisdiction. Mr. Boustany commented that a firm that outsources its services has a duty to meet MiFID standards and, in the context of a subadvisory relationship, may seek to impose contractually on its non-EU subadviser the responsibility to meet significant aspects of MiFID compliance.

Distribution into the EU. Mr. Kramer described the Packaged Retail Investment Products ("PRIPs") initiative, which began several years ago as a broader initiative to regulate financial products sold to retail investors through a variety of channels, including fund managers, insurance, and banking. The EU is expected to produce a draft legislative proposal in April 2012, which will likely address (a) transparency, through mechanisms such as mandating a generalized variation on the KIID for other retail products, and (b) harmonized selling, so as to have closer equivalency for different means of reaching retail investors.

Mr. Waters discussed the implications of MiFID II for European distribution, which would regulate such functions as commissions paid to distributors and bank-based relationships. Other changes, such as reporting obligations under the AIFMD, regulations on remuneration, and rating agency controls under ESMA, have left the regulatory landscape in a state of great flux. The panelists agreed that one goal of these varied regulations is to create a "level playing field" for distribution of different types of products throughout Europe, and noted that the rapid pace of change may open opportunities for global players to gain market share.

Key Changes to UCITS. Mr. Kramer commented on developments in UCITS, which has increasingly supported sophisticated products and alternative strategies. He noted the challenges facing efforts to regulate such strategies and posited that one attractive approach would be to focus disclosure and regulation around the intended outputs of a fund's strategy, such as absolute return or risk-hedged capital appreciation, rather than narrowly seeking to regulate particular instruments or practices. Mr. Boustany observed that the cross-border merger provisions under UCITS IV have been well-received and used by the industry, noting that EU regulators have been relatively successful at supporting innovation in investment products. Mr. Ouellette commented on practical difficulties for reducing complicated strategies into the disclosure format required for the KIID; for instance, his firm has considered reducing the number of share classes its funds offer due to the requirement that each authorized share class have its own KIID, potentially in multiple translations, regardless of whether the share class is actively being sold.

Mr. Waters outlined the expected subjects for UCITS V, which will focus on compensation and the use of depositaries. Mr. Williams stated that UCITS V will increase the responsibility placed on custodians, which may result in increased administrative costs for UCITS funds.

Workshop 2-A: Alternative Investment Strategies in the Registered Funds Space

Moderator: Robert C. Grohowski, Senior Counsel, Investment Company Institute

Speakers: Ruth S. Epstein, Partner, Stradley Ronon Stevens & Young, LLP
Brendan R. Kalb, General Counsel, AQR Capital Management, LLC
Michael W. Schnitman, Director of Product Strategy and Development, Putnam Investment Management
Cindy Erickson Zarker, Director, Cerulli Associates

Industry Trends. Ms. Zarker commented regarding industry trends with respect to retail alternative investment products. She indicated that alternative strategies remain an important area of product development, and that their newness and complexity often cause alternative strategies to overshadow other strategies. She indicated that differing views as to what the term "alternative" means underscore the need for clear-cut product labeling, and presented survey data indicating that an increasing percentage of fund firms consider strategies such as global tactical asset allocation to be "traditional" rather than "alternative" strategies. Ms. Zarker also observed that alternative strategies are playing an evolving role in investor portfolios, as many managers now view alternatives as "risk mitigators" rather than "risk enhancers" due to their lack of correlation to traditional asset classes.

Product Development Process. Mr. Schnitman discussed the alternative product development process. He noted that in his firm's case, idea generation focuses on various themes intended to meet investor needs, including strategies to help investors earn income and to manage longevity risk, inflation risk and market volatility. Mr. Schnitman noted that as part of the due diligence process, new product ideas are often discussed with gatekeepers as a form of market testing. He also discussed the process of presenting alternative products to fund boards, noting that alternative product launches may require more discussion with boards and their counsel than more traditional strategies.

Legal and Regulatory Considerations. Ms. Epstein commented regarding the many legal and regulatory considerations that must be considered for alternative strategies during the design phase. She noted that alternative products require consideration of all of the "classic" new product regulatory issues, including whether the strategy can work within the leverage and liquidity limits of the 1940 Act, and whether the strategy poses special valuation, side-by-side investment or joint and affiliated transaction issues. She noted that at a February 2012 "SEC Speaks" conference, a representative of the SEC's Office of Inspections and Examinations ("OCIE") noted that funds with alternative strategies will be a priority for OCIE's inspection team, in part due to valuation and liquidity challenges.

Mr. Kalb discussed the implications of the CFTC's recent amendments to regulations under the Commodity Exchange Act, including Rule 4.5. He noted that under the amended rule, a fund claiming the Rule 4.5 exclusion will be subject to both a trading threshold test and a marketing restriction test, and that advisers to funds that are unable to comply with these tests will be required to register as commodity pool operators. Mr. Kalb noted that many interpretive questions relating to revised Rule 4.5 remain, including how to perform the calculations needed to determine whether a fund exceeds the trading thresholds and how various CFTC requirements will be harmonized with existing SEC requirements.

Implementation/Registration Phase. Mr. Kalb noted that it can be challenging to describe a complex alternative product's strategies and risks in plain English, summary form. Ms. Epstein discussed special challenges for fund boards with alternative funds, noting that these funds often have higher fees compared to other products. She noted that boards need to evaluate the manager's skill with alternative strategies and understand the justification for the proposed fee. She also commented regarding the SEC staff's efforts to apply Rule 35d-1 under the 1940 Act (the so-called "names rule") to the term "alternative." Ms. Epstein noted that most funds use the term to describe a strategy, not a type of investment, and as such have not adopted names tests relating to this term.

Rollout Phase. Ms. Zarker discussed the challenges associated with developing marketing materials for alternative funds, including how best to describe the need the product is intended to serve and, for broader asset allocation products, how the fund uses alternative strategies. Mr. Kalb discussed Financial Industry Regulatory Authority, Inc. ("FINRA") Regulatory Notice 12-03 regarding heightened supervision of "complex" products" and its possible application to alternative registered funds. He noted that alternative managers entering the registered fund space may be in for a bit of culture shock as they work through channel conflicts and other challenges associated with managing heavily regulated registered funds.

Workshop 2-B: In the Crosshairs: Focusing on the Fixed Income Markets

Moderator: Heather L. Traeger, Partner, O'Melveny & Myers

Speakers: Cadmus Hicks, Managing Director, Nuveen Asset Management
Kristine M. Nishiyama, Senior Vice President, Capital Research and Management Company
Malcolm Northam, Director of Fixed Income Regulation, Financial Industry Regulatory Authority, Inc.

Impact of Increased Regulation on Fixed Income Markets. Ms. Traeger stated that the 2008 economic crisis and its aftermath have led to a dramatic increase in regulation (both adopted and pending) and regulatory scrutiny of the fixed income markets, both in the U.S. and globally. She noted, in particular, that the Dodd-Frank Act and the piecemeal development of regulation thereunder has caused a high level of uncertainty for fixed-income market participants and is likely to have significant unintended consequences on how these markets function.

Mr. Hicks discussed certain potential unintended consequences of the Volcker Rule and other Dodd-Frank provisions on the market for municipal tender options bonds ("TOBs"). He noted that banks frequently manufacture and sponsor TOBs, own residual and other ownership interests in the trusts that issue TOBs and provide credit and liquidity enhancements that support securities issued by TOBs trusts, thus serving both investment banking and commercial banking functions in TOBs market. He pointed out that, while Dodd-Frank and the Volcker Rule do not specifically refer to TOBs, TOBs appear to satisfy the definition of a "covered fund" under the Volcker Rule (because most TOBs trusts are structured as 3(c)(1) or 3(c)(7) funds) as well "asset backed securities" under Sections 621 and 941 of Dodd-Frank, and that associated proprietary trading, conflicts of interest and "risk retention" regulations may severely limit banks from participating in the TOBs market, unless related exemptions are provided.

Ms. Nishiyama added that, by decreasing the role of banks, the Volcker Rule may significantly reduce liquidity and increase volatility in the municipal bond and other fixed income markets. She noted that these developments could, in turn, make the portfolio security valuation process more difficult and less reliable due to a reduction in the number of transaction-based pricing points available.

Trends in Fixed Income Markets. Mr. Northam discussed data indicating that the fixed income markets have become more retail-oriented in recent years, with higher numbers of individual fixed income transactions taking place at smaller denominations. He emphasized that FINRA expects member firms to fully observe their diligence, disclosure, suitability and pricing obligations when marketing fixed income products, particularly to retail investors. He noted that firms are not relieved of their duties to disclose material information to clients simply because that information is otherwise publicly available, must use available market price information to establish a fair sales price/mark-up for the customer, and must perform an independent analysis of the securities they sell and not simply rely on credit ratings.

Mr. Northam reported that FINRA has benefited from substantially increased trade reporting and transparency in the U.S. fixed income markets, in part through FINRA's Trade Reporting and Compliance Engine (TRACE), which has been expanded to require FINRA members to report transactions in U.S. government securities and mortgage-related and other asset-backed securities. He said that these and other new reporting requirements have greatly enhanced FINRA's ability to survey for fraud, manipulation, unfair pricing, and other misconduct from FINRA's home offices, and have also provided useful enhanced transparency for fixed income market participants. He noted, however, that banks and others who are not FINRA members are not required to report on TRACE, which leaves a significant gap in fixed income trade information that is available to FINRA.

Anticipated Impact of Dodd-Frank Act and Volcker Rule. Ms. Traeger summarized various features of the Dodd-Frank Act that will expand the SEC's oversight of nationally recognized securities ratings organizations (NRSROs), impose new governance, compliance, disclosure, and other regulations on NRSROs, and generally minimize the role of credit ratings in the U.S. financial regulatory regime. She noted that Section 939A of the Dodd-Frank Act requires the SEC and other federal agencies to assess their regulations and ultimately replace references to credit ratings with alternative standards of credit-worthiness. She reported that the SEC has already adopted various rules and proposed others to eliminate references to credit ratings in certain regulations and forms under the securities laws, including several relating to registered investment companies (*e.g.*, proposed amendments to Rules 2a-7 and 5b-3 under the 1940 Act).

Ms. Traeger summarized various features of Dodd-Frank targeted at asset-backed securities (ABS). Among reforms that have been adopted, she noted that ABS issuers must now perform an asset review in connection with an offering and disclose their findings in the registration statement. She summarized various noteworthy ABS-related proposals that have not yet been finalized, including the so-called "risk retention rule," which would generally require sponsors/securitizers of ABS to retain at least 5% of the credit risk relating to assets that underlie ABS, and proposed Rule 127B under the 1933 Act, which would prohibit any ABS securitization participant from engaging in any transaction that involves or results in a material conflict of interest between the participant and an investor. She noted that the SEC is also considering modifications to the conditional exclusion from the definition of "investment company" for ABS issuers in Rule 3a-7 under the 1940 Act.

Ms. Nishiyama and Mr. Hicks commented on uncertainties raised by the various proposed ABS regulations, including that the proposed risk retention rule, together with the Volcker Rule, could significantly reduce the role of banks in the ABS market, with the potential for reduced market liquidity and/or the replacement of banks by less regulated liquidity providers. Mr. Northam stressed that FINRA expects its members to fully understand these securities and their related risks and to observe related disclosure, suitability and fair pricing obligations in recommending and selling ABS to clients.

General Session: Dodd-Frank Implementation – Are We There Yet?

Moderator: Frances M. Stadler, Senior Counsel, Investment Company Institute

Speakers: Amy Friend, Managing Director, Promontory Financial Group, LLC
David A. Luigs, Counsel, Debevoise & Plimpton LLP
Laura J. Merianos, Principal, The Vanguard Group, Inc.
David Oestreicher, Vice President and Chief Legal Counsel, T. Rowe Price Associates, Inc.

This panel discussion focused on the implementation of the Volcker Rule and the regulation of systemic risk. Ms. Stadler stressed that her chief concern is that the Volcker Rule and regulation of systemic risk will affect mutual funds far more than intended by Congress. She said that the preamble to the proposed Volcker Rule noted that mutual funds would not be considered subsidiaries or affiliates of banking entities if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages a mutual fund in accordance with the Bank Holding Company Act.

The Volcker Rule. Ms. Friend provided a history of the Volcker Rule, noting that at its earliest stage it was simply a one sentence concept that the U.S. Government should support core banking operations but should not support banks' proprietary trading and high risk activities. Mr. Luigs discussed the statutory authority for the Volcker Rule. He said that the statute itself applies only to "covered banking entities," a term which generally includes all of the entities in a family of affiliated companies if the family of companies includes an insured depositary institution. He noted that the definition of "affiliate" for these purposes is quite broad, and that the Volcker Rule would generally reach the entire world-wide operations of any foreign bank with a U.S. banking presence. He noted that transactions, like new joint ventures with affiliates of banks, will need to be scrutinized carefully to ensure the Volcker Rule implications are understood.

Mr. Luigs described certain prohibited activities under the Volcker Rule, noting that the Rule includes bans on proprietary trading and investments in or sponsorships of hedge funds and private equity funds. He noted that "proprietary trading" was defined quite broadly to include engaging as principal for the trading account of a covered banking entity in any purchase or sale of one or more covered financial positions, but that it does not include acting solely as agent, broker or custodian for an unaffiliated third party. He noted that the terms "hedge funds" and "private equity funds" were proposed to be defined quite broadly to include any entity that would be an investment company under the Investment Company Act of 1940 but for Sections 3(c)(1) or 3(c)(7). He noted that such a definition would encompass many entities not typically considered to be hedge funds or private equity funds.

Mr. Oestreicher advised that registered investment companies should be concerned with the operation of the Volcker Rule even if they do not have any banking affiliates. He noted that the exception for market making activity by covered banking entities is not as clear as it could be and that certain bank market makers are expected to leave certain markets unless further clarification is provided. He stated that such departures from a market will lead to increased trading costs and decreased liquidity for registered investment companies, especially in the fixed income markets.

Ms. Merianos stressed the potential for decreased liquidity in certain markets. She said that the tender option bond market would be severely affected because the issuing entities of such bonds are generally 3(c)(1) or 3(c)(7) entities and those entities are generally sponsored by banks. She also noted that the Volcker Rule generally prohibits covered banking entities, as principal, directly or indirectly, from sponsoring, acquiring, or retaining any ownership interest in any covered fund. She noted that this prohibition could be particularly important to the trading and formation of ETFs that may be covered funds, because bank-related entities represent up to 90% of trading by authorized participants in certain ETFs.

Mr. Oestreicher said it was unclear under the Volcker Rule whether registered funds could be "covered funds" for purposes of the Rule. He noted that commodity pools were considered to be covered funds under the Volcker Rule, as proposed, and he said that the pending changes to the regulations under the Commodity Exchange Act would add to the lack of clarity. He noted that there are restrictions on a covered financial institution's ability to provide seed investments for covered funds. He noted that his firm has a banking entity in its affiliated family and that any seeding position undertaken by the firm will need to be reduced to 3% of the seeded entity or eliminated entirely within one year unless changes to the proposed Volcker Rule are made.

The panelists then discussed the large volume of comment letters regarding the Volcker Rule and the possibility of a re-proposal of the related releases. The participants generally did not believe re-proposals were likely, but stressed the importance of making the regulators aware of the unintended consequences and the problematic ambiguities or interpretations under the Volcker Rule. The panelists were generally optimistic that working with the regulators would lead to helpful clarifications.

Regulation of Systemic Risk. The panelists then discussed the role of the Financial Stability Oversight Council ("FSOC") and the potential designation of registered investment companies as nonbank systemically important financial institutions ("SIFIs"). The panelists discussed the proposed criteria for determining whether an entity is a SIFI. They noted that the existing guidance is not binding on the FSOC, but they stressed the need for criteria specific to the asset management industry, as many of the existing criteria are not applicable to registered funds and their advisers. Ms. Merianos said she thought it would be unlikely for a registered fund to be designated as a SIFI in the first round of designations. The panelists expressed the view that further successful money market reform could significantly reduce the likelihood of a money market fund being designated as a SIFI. Ms. Merianos noted that all new products in the asset management industry should be evaluated in light of systemic risk issues, particularly the potential designation of related entities as SIFIs.

Mr. Luigs discussed the potential effects of a registered fund being designated as a SIFI. He noted that the fund would be subject to prudential regulation designed to limit the probability and consequences of its failure. He noted that such a fund would be subject to intrusive supervision, including on-site examiners who would have unfettered access to the fund's business. He noted that such a fund would be expected to be subject to capital requirements more severe than those applicable to most bank holding companies.

In their concluding remarks, the panelists stressed the importance of educating the regulators about ambiguities and unintended consequences under the Volcker Rule.

Workshop 3-A: Changing Distribution Dynamics: Operational Challenges Lawyers Should Understand

Moderator: Martin A. Burns, Director, Institutional Operations and Service, Investment Company Institute

Speakers: Peter G. Callahan, Senior Vice President, AllianceBernstein Investor Services, Inc.
Jesse H. Cole, Managing Director, Goldman Sachs & Co.
Kathleen T. Ives, Senior Vice President and Director of Internal Audit, OppenheimerFunds, Inc.

Increasing Use of Omnibus Accounts. Mr. Callahan noted that during the past decade, and in particular in the last 2-3 years, mutual fund shareholder accounts have increasingly moved from direct accounts on the books of mutual fund transfer agents to omnibus accounts held by financial intermediaries that, in turn, maintain shareholder-level accounts and provide all shareholder services to such accounts. He described a range of practices employed by mutual funds and their transfer agents and distributors to oversee and monitor such accounts, and to provide assurance that financial intermediaries are complying with applicable prospectus and regulatory requirements. Ms. Ives noted that, given the number and variety of intermediaries holding omnibus accounts, it was impractical for most fund groups to conduct diligence visits to each such financial intermediary. She explained that most fund groups make risk-based assessments of intermediaries to determine how best to allocate their oversight and monitoring resources.

Mr. Callahan noted that financial intermediaries typically provide a variety of information to mutual fund transfer agents regarding their underlying accounts and accountholders, including sales information, transaction information under Rule 22c-2 agreements, information regarding sales attributable to particular wholesalers, and, for some intermediaries, SAS 70/SSAE 16 or attestation reports. The panelists emphasized the importance of understanding what types of information are received from intermediaries, in order to mitigate the risk that a fund or its transfer agent might be deemed to have failed to respond appropriately to information in its possession. For example, Ms. Ives noted that mutual fund transfer agents should carefully consider the scope of SAS 70/SSAE 16 reports they receive, rather than focusing only on exceptions noted, and recommended that transfer agent personnel obtain training from their accounting firms regarding how best to review such reports.

Impact of Growing Registered Investment Adviser Channel. Ms. Ives discussed various issues arising out of the growing registered investment adviser channel for mutual fund transfer agents. She noted that, for accounts that are not associated with a broker-dealer, it is important to consider what functions may be performed by the fund's distributor and transfer agent. She emphasized the importance of specifying the responsibilities of a financial intermediary as clearly as possible in relevant agreements. In response to questions, the panelists commented on varying approaches taken by their firms with respect to the allocation of sub-transfer agency expenses between the funds and the transfer agent or distributor.

Dealing with Regulatory Actions. Mr. Cole commented on the significant expense recently incurred by mutual fund transfer agents to implement cost basis reporting, and commented on the difficulties that various types of financial intermediaries would likely face if money market funds were to implement floating NAVs. The panelists agreed that, in the event money market funds are required to implement floating NAVs, it will be important for the ICI to coordinate an effort to develop a uniform solution to operational issues. Mr. Cole noted that grandfathering existing clients when regulations change can, in some cases, have the perverse effect of doubling the operational work, as separate solutions may need to be developed for grandfathered and non-grandfathered universes.

Workshop 3-B: The Evolving OTC Derivatives Market: Current Issues for Funds

Moderator: Sarah A. Bessin, Senior Counsel, Investment Company Institute

Speakers: Nevis Bregasi, Vice President and Senior Counsel, MFS Investment Management
Susan C. Ervin, Partner, Davis Polk & Wardwell LLP
Victor M. Frye, Chief Compliance Officer, ProShare Advisors, LLC

Current Status of CFTC and SEC Dodd-Frank Title VII Rulemakings. Ms. Ervin opened her comments by observing that the Dodd-Frank Act was forged in a financial crisis and reflects Congress' apparent desire to create a legislative remedy as large as the crisis. She reviewed the status of the CFTC's and the SEC's rulemaking initiatives to date, noting that while both the CFTC and SEC had missed a number of deadlines imposed under Dodd-Frank, the CFTC had finalized a greater percentage of its assigned rules. She commented on the CFTC's and SEC's efforts to coordinate on rulemaking issues, including through regular interagency meetings, but noted that the agencies' agendas and timetables had parted in recent months. Mr. Frye and Ms. Bregasi discussed the challenges of waiting for rules from two different regulators working at different paces. Mr. Frye noted that his firm's approach in cases where the CFTC has gotten ahead of the SEC is to work from the CFTC structure, and to assume that while the analogous SEC requirements may differ, there will be many similarities. Ms. Bregasi noted the challenges of building internal systems to comply with both CFTC and SEC rules, and remarked that, as a practical matter, firms will be forced to the more conservative of the two agencies' approaches on every issue.

Entity/Product Definitions. Ms. Bessin noted that 18 months after the passage of Dodd-Frank, the industry is still waiting for a final definition of "swap" and other key terms necessary to define the reach of the new requirements. Mr. Frye stated that final rules for various "entity definitions" were expected in March 2012, including the terms "swap dealer/security-based swap dealer" and "major swap participant/major security-based swap participant." He noted that most funds would be excluded from the major swap participant and major security-based swap participant classifications and thus the many related requirements. Mr. Frye reviewed pending joint CFTC/SEC "product definitions", including definitions of swap, security-based swap, and other key terms. He noted that the eventual effective date of the swap definition will trigger the effectiveness of many other new swap rules under Dodd-Frank. Ms. Ervin commented regarding a pending Treasury proposal to exempt foreign exchange swaps and forwards. She noted that based on proposed rulemaking, the exemption would not apply to non-deliverable swaps and forwards, resulting in similar trades being regulated in a very different manner.

Mandatory Clearing and Trade Execution. Ms. Ervin noted that mandatory clearing of swaps applies whenever the CFTC or SEC determines a swap must be cleared, unless no clearing facility is willing to include the swap. Ms. Bregasi reviewed a number of issues that funds should consider in the months leading up to mandatory clearing deadlines. She stressed the importance of understanding applicable deadlines, noting that if funds lack the necessary capability to trade cleared swaps, they will be locked out of the market for some period of time. She also stated that while funds probably will not be required to clear until February 2013, considerable work needed to be completed before that time. Ms. Bregasi noted that funds may want to clear before the mandatory deadlines to avoid paying higher margins/penalties in the OTC markets. She also noted that funds will need to consider how to divide their business among futures commission merchants ("FCMs"), since employing a larger number of FCMs reduces the benefits of netting and results in higher margin requirements. She stated that funds may also want to consider which clearinghouses they use, as different clearinghouses will have different guaranty funds and different portability terms in the event an FCM becomes insolvent. She also noted that while legal documentation will be a major focus in the coming months, preparing for the clearing deadlines will also require coordination across a firm's operations, information technology, risk management, and trading units.

Treatment of Collateral. Ms. Bregasi noted that whereas funds are not currently required to post any margin on swaps, Dodd-Frank rulemaking will impose margin requirements for both cleared and uncleared swaps, with higher margin requirements for uncleared swaps. With respect to the treatment of uncleared swap collateral, she noted that margin requirements are not bilateral and that funds will need to negotiate their own protection. With respect to the treatment of cleared swap collateral, Ms. Bregasi discussed the "legally separated, operationally commingled" ("LSOC") model adopted by the CFTC, which provides that if a customer of an FCM or an FCM default on cleared swap margin obligations, the clearinghouse has no recourse to funds of the FCM's non-defaulting customers. She noted that it remains to be seen what would occur if an FCM's daily reporting to its clearinghouse regarding each client's funds were to break down.

CFTC Swap Reporting Rules. Mr. Frye provided an overview of the CFTC's swap recordkeeping and reporting requirements. He noted that most reporting requirements fall on swap dealers, not funds.

Workshop 3-C: Social Media Opportunities and Challenges

Moderator: Alexander C. Gavis, Vice President and Associate General Counsel, Fidelity Investments

Speakers: Rajib Chanda, Partner, Ropes & Gray LLP
Mark Diamond, CEO and President, Contoural, Inc.
Susan B. McGee, President, U.S. Global Investors, Inc.
Thomas A. Pappas, Vice President, FINRA

Mr. Gavis led the speakers through a series of hypotheticals to illustrate considerations pertaining to the use of social media communications by asset management firms. The speakers began by assessing the benefits and risks of using social media such as *Facebook, Twitter*, and *YouTube* for advertising.

Pros: Social media can be a cost effective method of distributing content (such as research pieces) to investors and potential investors (Ms. McGee).

Social media can be a cost effective way for smaller firms to raise their profiles, and can be especially productive if it results in referrals back to the firm's website (Ms. McGee).

Firms without a social media presence will soon be at a disadvantage (Mr. Diamond).

Cons: There is some cost to ensuring that the compliance department is capable of providing quick review of social media communications (Ms. McGee).

It can be difficult to reach an internal consensus with respect to a social media strategy, as legal, compliance, information technology, sales and marketing, and senior management all have a stake (Mr. Diamond).

There is a relative lack of guidance in this area (Mr. Diamond).

Other considerations: Adopting a social media strategy requires a firm to consider privacy, data security, the potential for dissemination of material nonpublic information, the potential for social media communications to disrupt private placements of securities, recordkeeping, and employment law (Mr. Chanda).

Because the current regulatory guidance is principles-based and fairly flexible, there is a premium on the careful evaluation of how and why a firm seeks to use social media (Mr. Chanda).

Firms should evaluate five possible uses ("channels") of social media: (1) corporate communications (such as press releases); (2) commentary from individuals at the firm; (3) forums/discussion groups; (4) the use of social media in the performance of employees' daily jobs; and (5) personal use (Mr. Diamond).

Mr. Pappas said that FINRA's goal in regulating the use of social media by its member firms was to balance investor protection with the ability to communicate using up-to-date technology. He said that FINRA had provided guidelines, rather than rules, which were focused on recordkeeping and supervisory issues and could be applied to any technology. Mr. Pappas stated that FINRA did not have any flexibility in interpreting the SEC's recordkeeping rules. In contrast, he said, FINRA could be more flexible in interpreting its own rules, such as those regarding supervision and content standards. He noted that firms using social media were required to have written supervisory procedures covering these communications, and that field exams focused on these procedures, evidence of actual supervision (without which, he said, the examiners would conclude that there is no actual supervision), a record of training, and a red flags system and evidence that the firm takes actions when red flags are raised.

Use of Social Media for Business or Mixed Use Communications. The next hypothetical involved a pilot program allowing a small number of employees to use *Facebook* and *LinkedIn* for business purposes. Mr. Chanda noted that, in developing a policy regarding the use of social media, a firm should consider whether the use of social media would be for business purposes only or for mixed business and personal use. He commented that mixed use communications could be more powerful in building relationships, but also introduced complications. Mr. Chanda offered several recommendations, including that employees engaging in mixed use communications should be aware that the firm will keep records of their communications so that their expectation of privacy will be very low; firms should consider whether state employment law limits their ability to restrict their employees' use of *LinkedIn*; and firms should examine whether links or recommendations may be testimonials under FINRA's rules or the Investment Advisers Act of 1940. Mr. Chanda suggested that a policy prohibiting employees from linking sites, such as by adding tweets to a *Facebook* page, might be useful in limiting firms' recordkeeping obligations. Mr. Pappas then suggested that it might also be useful for supervisory policies to prohibit personal use of social media touching on the person's business, and to provide templates for responding to business-related inquiries received through a personal account. Mr. Diamond also recommended that policies should address who owns particular accounts once an employee leaves the firm. In response to questions, Mr. Pappas explained that FINRA generally did not hold a firm accountable for any third party statement unless the firm *adopted* or reused the statement or became *entangled* in the statement (such as by pre-arranging responses with the third party).

Mr. Pappas said that FINRA's August 2011 notice on social media made it clear that whether a communication is business or personal depends on the content of the communication and not on the technology or device. Mr. Diamond said that firms typically either provided a device for business use only or permitted employees to use their own device for business and personal use ("byod" – bring your own device). He said that firms could place "data envelopes" around the business communications on an employee's device, which synched to the firm's services and permitted the firm to "wipe" the device remotely. Ms. McGee recommended that employees provide a quarterly certification that any business communication made using a personal device had been forwarded to the firm for recordkeeping. Mr. Chanda also advised that, before permitting the use of new devices for business or mixed use, it was critical that the information technology group be confident that it had appropriate controls over the new device.

Use of Social Media for Internal Communications. The panelists then considered the creation of an internal collaboration platform through which employees could communicate with one another, whether in the office or on the road. Ms. McGee noted that cloud services, or the use of a "dump box," could be useful in security and recordkeeping. Mr. Chanda noted that, while many communications on an internal collaboration platform would likely not be required records, it may be good practice to employ a regular retention and destruction protocol for all of these communications. Mr. Chanda advised that care should be taken to avoid the dissemination on the internal platform of material nonpublic information. He also noted that firms should be mindful of limits upon their ability to restrict speech on internal platforms. Mr. Diamond and Ms. McGee stressed the importance of periodic employee training, preferably in small groups and containing specific examples. Mr. Pappas commented that FINRA considers the institutional sales literature rule (NASD Rule 2211) to apply to internal communications and confirmed that there was no other FINRA guidance on this point.

Preservation of Records for Litigation. The panel also considered firms' obligations to preserve social media communications in a litigation discovery scenario. Mr. Chanda said that social media communications can be relevant to litigation and thus discoverable, and that litigation hold policies should cover social media. He said that, while firms would have no control over the actions of social media services such as *Facebook*, it would also be prudent to direct *Facebook* not to delete information in the firm's and its employees' accounts. Mr. Gavin noted that firms needed both recordkeeping and retrieval capabilities. He noted that retrieval can be challenging for social media communications, which have a tendency to be non-linear.

Workshop 4-A: Waiting for Answers: Unresolved Issues in Mutual Fund Civil Litigation

Moderator: Daniel Steiner, General Counsel, ICI Mutual Insurance Company, RRG

Speakers: Janet D. Olsen, General Counsel, Artisan Partners Limited Partnership
John W. Rotunno, Practice Area Leader, K&L Gates LLP
Robert A. Skinner, Partner, Ropes & Gray LLP

Litigation Under the 1933 and 1934 Acts. Mr. Skinner reviewed the structure of mutual fund civil litigation under the Securities Act of 1933 (the "1933 Act"), explaining that in actions brought under Sections 11 and 12(a)(2) of the 1933 Act, unlike actions brought under Section 10(b)(5) of the Securities Exchange Act of 1934, the plaintiff need not prove scienter or reliance on alleged misstatements or omissions. He noted that most of the defendants' efforts at the motion to dismiss stage of actions under the 1933 Act relate to whether the alleged misstatement or omission is material in light of the statements made in the prospectus and whether the alleged misstatement or omission caused the plaintiff's loss.

Mr. Skinner stated that civil actions under the 1933 Act typically allege that a risk was not properly disclosed. He stated that while historically courts were generally willing to say that the fund's disclosure was sufficient, more recently, courts have found that, based on the overall mix of disclosure, a reasonable investor could potentially have been misled, underscoring the importance of loss causation. Mr. Skinner explained that the recent Yu case had held that because the price of an open-end fund share is based on the fund's NAV, an alleged misstatement that does not affect the fund's NAV cannot give rise to a loss recoverable under Section 11 of the 1933 Act. Mr. Skinner noted that other courts had reached a different conclusion. Mr. Skinner cautioned that, even if the holding in Yu were to be universally adopted by courts, loss causation arguments should not lead open-end funds, their directors, or other service providers to be careless with disclosures, in light of the possibility of civil litigation under Section 10(b)(5) of the 1934 Act, as well as the SEC's ability to enforce the federal securities laws. Mr. Skinner also noted that, notwithstanding changing strategies and market conditions that might prompt changes in disclosures over time, plaintiffs' lawyers often seek to use changes in disclosures to suggest that earlier versions of such disclosures were inadequate.

Litigation Under the 1940 Act. Mr. Skinner reported on the effect of the Supreme Court's recent Janus decision on subsequent fund litigation. He explained that the decision did not eliminate potential liability for an investment adviser as a control person of a fund, though a plaintiff would still need to establish a scienter-based primary violation. Ms. Olsen stated that the Janus case should not have any impact on the relationship between a fund's directors and its adviser.

Mr. Rotunno reported on recent developments in civil litigation under Section 36(b) of the Investment Company Act of 1940, noting that the Jones case is still under appeal in the Seventh Circuit. He explained that the plaintiffs in the Jones case continue to argue that a deficiency in the Section 15(c) process can itself give rise to a claim under Section 36(b). Mr. Rotunno reported that the Gallus case, involving similar allegations, is currently under appeal in the Eighth Circuit. Ms. Olsen pointed out that the Section 15(c) process remains, as the rigor of the process is likely to bear on the weight given to the fund board's conclusions by a court in a Section 36(b) action. Ms. Olsen also noted that Jones and other decisions under Section 36(b) are primarily intended for use by courts in reviewing Section 36(b) cases, rather than by directors in considering whether to approve advisory and distribution agreements. Mr. Rotunno reported that the Ninth Circuit, in affirming a district court ruling for the defendants in the American Funds case, indicated its agreement that Section 36(b) can be implicated by the improper use of fees. Mr. Skinner noted that the "improper use" theory could potentially open a back door to private actions under other sections of the 1940 Act.

Mr. Rotunno explained that, due to relatively stringent pleading standards under the Private Securities Litigation Reform Act of 1995, and potentially in the hope of finding a more receptive forum, the plaintiffs bar has gravitated to state law claims in recent years. Mr. Rotunno explained that the Securities Litigation Uniform Standards Act of 1998 (SLUSA) can be an important tool in defending against class actions brought under state law involving an alleged misrepresentation or omission in connection with the sale of a registered security.

Workshop 4-B: Beyond Investments: Additional Risks Keeping Financial Services Professionals up at Night

Moderator: Tamara K. Salmon, Senior Associate Counsel, Investment Company Institute

Speakers: Daniel S. Bender, Managing Director, Risk Consulting, KPMG LLP
William D. Mennonna, Director of Risk Management, Pioneer Investments
Holly H. Miller, Managing Director, Middle Office Outsourcing, SEI
William L. Roland, Vice President, Investment Risk, ICMA Retirement Corporation

Process Risks. The panelists discussed process risks, or "traps for the unwary," that compliance and risk professionals should consider in designing programs for fund firms. The panelists first discussed the belief that risks are not present because a firm runs a "well-oiled machine." Mr. Bender said this was a trap for the unwary because comprehending the significance and totality of risks is a fundamental aspect of understanding risk, and that the totality of risks included risks beyond the four walls of the company. Mr. Bender also said that overconfidence could lead to a failure to think outside the box, a failure to heed warnings, a culture where individuals do not raise concerns, and a failure to learn from industry experience.

The second identified process risk was the belief that risks are not present because a firm only employs the "best and the brightest." Ms. Miller said that hiring talented people is only the first step. She noted, for example, that when firms seek to do more with less, as in the recent economic downturn, there is a risk that staff will shortcut processes to save time, or simply because they are tired. Ms. Miller said this could also be a trap for the unwary because it might lead to assumptions of competence that are not appropriate, especially when trading new instruments or in new markets. Ms. Miller also noted that if a firm fails to discourage silos of information and encourage cross-training and functionality, it may not understand the full extent of its risk profile when certain employees leave the firm.

The panelists also discussed the belief that risks are not present because a firm uses only the best technology. Mr. Mennonna cautioned that even the best technology cannot eliminate human error. He suggested that the primary method to overcome this process risk is communication, citing the example of encouraging more communication between portfolio management and the trading desk to reduce trading errors. Mr. Mennonna said that firms also need to be wary of external vulnerabilities, such as those that arise from cyber-terrorists and hackers, and stated that the move to cloud computing increases those vulnerabilities. He recommended due diligence of service providers on a regular basis, and noted that insurance firms now offered cyber liability coverage. Mr. Mennonna said that internal vulnerabilities also existed, such as those that arise from the blending of personal and professional communication devices. He recommended systems that could "wipe" an employee device immediately if it were to fall into the wrong hands. Ms. Salmon cited a statistic that as many as 10,000 personal computers are left behind at airports every week, highlighting the need for such systems.

Substantive Risks. The panelists discussed substantive risks that should be of concern to compliance and risk professionals. Mr. Roland first discussed the risks of dwindling resources and revenue erosion, as it relates to the people at the firm. He said that while cost-cutting could be a useful exercise when it created greater efficiencies, unhealthy cost-cutting could lead to over-reliance on the strongest employees, employee fatigue and departures, which in turn could lead to the inability to detect wrongdoing.

Mr. Bender next discussed data system and security risks. He noted that the vast majority of data breaches are inadvertent and often are a result of employee neglect. Mr. Bender suggested implementing background checks for employees who handle private data and close oversight of third party service providers.

Ms. Salmon discussed reputation and headline risks. She commented on the importance of being aware of the issues facing the industry as a whole and being prepared to address those issues in the context of one's own firm. She cited market timing as an example where advisers and funds who were not implicated in the inquiries nonetheless needed to be prepared to speak to investors and their boards about the adviser's own policies and experience. Mr. Mennonna next discussed contingency planning risks. He stressed the importance of firms' preparation for myriad events, ranging from blizzards to power outages, noting that the failure to do so could lead to reputational harm. Ms. Salmon noted that a common mistake was to warn employees when such procedures were being tested, which lessened the effectiveness of the testing. Ms. Salmon then discussed regulatory, compliance, and litigation risks. In this regard, she stressed the importance of aligning policies with actual operating procedures. She said that misalignment was a "slam dunk enforcement action" for regulators.

Sleeping Aids. The panel last discussed "sleeping aids" for compliance and risk professionals, meaning those steps that a firm could take to mitigate the process and substantive risks described by the panel. Mr. Bender first discussed the use of workflow diagrams, operational reviews, metrics, ongoing risk-evaluation processes, error logs, operational reviews, and the creation of a culture that does not reward risk exposure. Ms. Miller next discussed human capital concerns. She suggested that firms conduct regular, anonymous employee surveys and interviews, as well as exit interviews, to solicit candid feedback. She recommended other creative solutions to ensure communication and to prevent silos from developing, such as day-long job swaps or office location switches, as well as periodic work-from-home days that have the added benefit of testing disaster contingency plans.

Mr. Mennonna discussed patching technological vulnerabilities through the use of workflow diagrams, error logs, testing and outside expert reviews. He also discussed the hiring of so-called "ethical hackers" to check the security of a firm's technological systems. Finally, Mr. Roland discussed methods of identifying dysfunction within an otherwise functioning organization, including through due diligence meetings, mock exams, and audits.

General Session: The New Enforcement Philosophy at the SEC: Are Routine Compliance Inspections a Thing of the Past?

Moderator: Thomas M. Mistele, Director, Chief Operating Office and Senior Counsel, Dodge & Cox

Speakers: Andrew Bowden, Associate Director, Investment Advisers and Investment Companies, Office of Compliance and Examinations, U.S. Securities and Exchange Commission
Ari Gabinet, General Counsel, Asset Management, Oppenheimer Funds, Inc.
Robert B. Kaplan, Co-Chief, Asset Management Unit, Division of Enforcement, U.S. Securities and Exchange Commission
John H. Walsh, Partner, Sutherland Asbill & Brennan LLP

Implications of Enforcement Attending Regular Inspections. Mr. Bowden first discussed the mission of the Office of Compliance and Examinations ("OCIE"), namely promoting compliance with securities regulations, preventing fraud, informing policy and identifying potential high risk practices. He stated that members of the Division of Enforcement ("Enforcement") were participating in routine OCIE examinations primarily for training purposes and to enhance information sharing within the SEC. He noted that the participation of Enforcement in an examination was always disclosed at the outset to funds and/or advisers being reviewed. In response to questions about the potential "chilling effect" of Enforcement's participation in examinations, Mr. Bowden stated that examinations were intended, among other things, to assess how rules are being applied in practice, how business practices are unfolding, and, more generally, to conduct sweeps. He emphasized, however, that it has always been true that an examination could lead to an enforcement action and stated that the participation by Enforcement in examinations promotes the ability of OCIE and Enforcement to align their priorities and cross-execute on the divisions' priorities.

Mr. Walsh then discussed the increase of enforcement actions in 2011, noting that there had been a 30% increase in cases brought against advisers and funds in 2011 as compared with previous years. He commented that, whereas examinations used to be preventive compliance reviews through which OCIE could assess risk, the risk assessment process has now been internalized and OCIE examinations are now focusing on firms with heightened risk to investors and market integrity. He noted that the increase in enforcement actions in 2011 reveals that examiners are indeed finding significant violations but also reflects enhanced collaboration between OCIE and Enforcement. Mr. Bowden confirmed that, in light of the SEC's limited resources, OCIE was using risk evaluation as a method of discerning how to intelligently deploy the SEC's resources.

In the Matter of UBS Global Asset Management (Americas) Inc. Mr. Gabinet discussed the recent action by Enforcement against UBS Global Asset Management ("UBS") where the SEC charged UBS with failing to properly price securities in 3 mutual funds, resulting in a misstatement of the funds' NAVs. Mr. Kaplan confirmed that valuation is a hot-button issue and emphasized that UBS failed to follow its own valuation procedures for a period of two weeks. The panelists then engaged in an inconclusive discussion regarding whether UBS self-reported this incident or whether the incident was detected through a routine examination. Setting this question aside, Mr. Kaplan stated that self-detection and self-reporting are important, but not determinative factors, in potential enforcement matters.

Evaluation of Compliance and Legal Staff by Enforcement. Mr. Mistele discussed the recent dismissal of an enforcement case against Theodore Urban, the former chief compliance officer and general counsel of a Washington-based brokerage and investment bank who allegedly had made recommendations to his firm about dealing with a rogue broker, including firing the broker, but was subsequently accused in an SEC civil action of failing to supervise that broker. In response to questions, Mr. Kaplan stated that Enforcement does not specifically target any individuals. He commented that, in addition to his role as chief compliance officer and general counsel, Mr. Urban supervised several business units. Mr. Kaplan stated that Enforcement generally evaluates whether the compliance or legal officer is complicit in the underlying conduct and, with respect to chief compliance officers, whether a failure in the design of policies and procedures aided and abetted the underlying fraud. He stated that Enforcement is looking for complete failure in fulfilling the responsibility of a gatekeeper, not just technical violations.

Metrics for Evaluating OCIE's Success. Mr. Bowden rejected the suggestion that OCIE would use the percentage of examinations that result in referrals to Enforcement as a metric of OCIE's success. Rather, he said that the goal of OCIE is to promote compliance. Mr. Bowden discussed OCIE's efforts to allocate resources to producing public risk alerts to the industry and to eliciting feedback from the industry. He stated that formal metrics for evaluating the success of OCIE were still under development. In response to a question, Mr. Bowden explained that the rate of referrals to Enforcement as a result of OCIE's examinations had not changed, but rather the rate of the adoption of OCIE's referrals had increased as a result of the creation of the new asset management enforcement unit within Enforcement.

Investigation of 15(c) Processes. Mr. Kaplan stated that Enforcement was carefully evaluating advisers' and boards' 15(c) processes, noting that the recent enforcement action against Morgan Stanley was a good example of the failure of an adviser to be sufficiently forthcoming to the board of directors regarding a subadvisory relationship. He stressed that Enforcement was not trying to be a fee-setter, but rather was trying to confirm that there was a robust board evaluation and that the adviser was providing accurate information to the board. Mr. Bowden stated that OCIE was focusing on situations that are outside of what would be considered reasonable.

Role of Settlements without Requiring Admitting Wrongdoing. Mr. Kaplan discussed the recent action by Judge Rakoff in the Second Circuit in rejecting a settlement between Citigroup and the SEC on account of his objection to the SEC's practice of permitting companies to settle cases without admitting wrongdoing. Mr. Kaplan stated that, although it was unsatisfying to reach a result in which the accused was not required to admit or deny wrongdoing, such settlements are an important part of Enforcement's ability to resolve cases efficiently and with an outcome consistent with the relief that could reasonably be obtained in litigation.

Lessons from Recent Enforcement Cases Regarding Expert Networks. Mr. Gabinet stated that recent expert network cases had provided the opportunity for all registrants to evaluate their procedures. He noted that registrants should carefully evaluate expert network firms and test the representations made by such firms. Mr. Walsh discussed a variety of questions that compliance and legal staff should evaluate, including the following: how an expert network firm is selected and whether compliance is involved in the diligence process; who reviews the terms of agreements and whether such agreements are reviewed by legal and compliance personnel; what kind of information is provided by an expert network firm and is there a risk of taint to such information; and whether compliance has follow-up procedures to review analysts' personal trades following meetings with expert network firms.

General Session: Keeping the Fox Out of the Henhouse: Using Principles of Behavioral Finance to Instill and Enforce an Ethical Culture Within an Organization

Speaker: Dr. Hersh Shefrin, Mario L. Belotti Professor of Finance, Santa Clara University

Dr. Shefrin's lecture used principles of behavioral finance and applied ethics to develop a framework for thinking about the importance and implications of firm culture in potential ethical failures and larger systemic breakdowns. In particular, he cited the work of psychologist Daniel Kahneman as instructive in understanding breakdowns in the financial sector such as control fraud, the S&L crisis, and the mortgage lending debacle of recent years. His basic contention throughout was that ethical culture, which goes beyond pure legal compliance, is an essential ingredient to continued success in the long term, and that understanding certain aspects of human psychology helps to identify potential structural weaknesses in a firm's ethical fabric.

"Aversion to Sure Loss" and "Overconfidence about Ability." Dr. Shefrin surveyed the audience with two examples to illustrate two key principles. In the first, audience members were asked to choose simultaneously between (a) a sure gain of $2,400 and (b) a 25% chance of a $10,000 gain but 75% chance of zero gain, and between (c) a sure loss of $7,500 and (d) a 75% chance of a $10,000 loss but 25% chance of zero loss. Consistent with broader trends, the audience overwhelmingly chose options (a) and (d), demonstrating the principle of "aversion to sure loss," namely that people are more likely to stand pat with a sure gain but will risk a larger, likely loss if they have a chance of avoiding any loss at all. In the second example, audience members overwhelmingly considered themselves better-than-average drivers, thus supporting the observation that people tend to be overconfident about their own abilities. These two traits,

which Dr. Shefrin termed culture pitfalls, arguably go a long way to explaining the psychological factors that led to the recent global financial crisis.

Culture Pitfalls Framework. Dr. Shefrin discussed a possible framework for measuring firm ethical culture, which tracks the factors of "aversion to sure loss" and "overconfidence about ability," together with "excessive optimism" (tendency to focus overly on the potential for improvement) and "confirmation bias" (people's tendency to favor information that confirms their existing beliefs), across several functional aspects of the day-to-day running of a company. He stated that, over time, firms with low scores on this framework had included several scandal-plagued companies such as BP, whereas firms with high scores had included significant success stories such as Ford.

Case Examples of Ethical Failures. Dr. Shefrin considered several examples of ethical failures that were driven or exacerbated by the tendency toward aversion to sure loss and overconfidence about ability. In the S&L crisis in the 1980s, companies such as Lincoln Financial engaged in "cash for trash" arrangements in part as a way to avoid sure losses that would have resulted from their exposure to long-term fixed-rate mortgages amid rising short-term liabilities. Effectively these were sophisticated Ponzi schemes that allowed S&L executives to be lauded as success stories despite the fact that their basic business had become functionally insolvent due to changing market conditions and the inability to shift to adjustable-rate mortgages. He also suggested that the deterioration of mortgage lending standards in the 2000s underscores how organizations such as Fannie Mae and Freddie Mac were driven to risky and ethically questionable behavior by the realization that competition from private sector players such as Countrywide would otherwise decimate their market share and render their business models unsustainable.

Proposals for Installing Strong Ethical Culture in Firms. Dr. Shefrin offered several suggestions for strengthening a firm's ethical culture. He suggested that incentive structures should be set from the top down, with a focus on appropriate alignment of executive compensation and financial rewards. He said that a firm should engage in active "stress testing" of the ethics and psychology of its employees, together with employing other tools for evaluating firm culture. He also stressed that ethical culture should be explicitly valued within the firm, and a clear statement should be made that ethical restraints are significantly more conservative than what is legally permissible.

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