2015 ICI CONFERENCE

ICI Mutual Funds and Investment Management Conference Summary

ROPES & GRAY

2015 ICI MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE

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General Counsel's Address

Speaker: David W. Blass, General Counsel, Investment Company Institute

On the occasion of the 75th anniversary of the Investment Company Act of 1940 (the "1940 Act"), Mr. Blass addressed three current trends. First, he expressed some concern about a form of "regulatory creep" in which specific oversight responsibilities were increasingly being assigned to boards of directors of registered investment companies whenever new developments or concerns arose. He said that, at times, boards were being asked to make judgments in areas requiring technical or other expertise, and that this had the potential to distract boards' attention from their oversight of investment performance and compliance.

Second, Mr. Blass discussed the current emphasis on financial stability. He reviewed the key responsibilities of the Securities and Exchange Commission (the "SEC") – to protect investors, to ensure fair, orderly and efficient markets, and to support capital formation – and noted that these responsibilities were somewhat in conflict with the responsibilities of bank regulators to protect the safety and soundness of banking institutions. Mr. Blass said that the current efforts of banking regulators to tame systemic risk would be harmful to investors if applied to mutual funds. He explained that banks leveraged their deposits to make loans and were thus susceptible to "run risk," but that investment companies were different because they were already substantively regulated – with respect to leverage and other matters – under the 1940 Act. He observed that stock and bond funds did not experience runs during the financial crisis, and said that because money market funds were governed by separate, highly specific regulations they should not be regulated like banks.

Finally, Mr. Blass addressed the SEC's current "Distribution in Guise" sweep examination. He observed that the title of the examination suggested that the Office of Compliance Inspections and Examinations ("OCIE") may have had a conclusion in mind at the outset. He then pointed out that funds' fees should not be considered "hidden" given the requirements to fully disclose total expense ratios, and said that fund expenses should not be challenged if they are approved by fund boards in their reasonable business judgment. Mr. Blass urged the SEC, if it concludes that changes in the regulation of distribution or shareholder servicing arrangements are required, to make such changes through a transparent rulemaking process.

Keynote Address

Speaker: Michael S. Piwowar, Commissioner, U.S. Securities and Exchange Commission

Commissioner Piwowar defended the regulatory framework for the investment management industry. He said that the prudential banking regulators' efforts to extend their oversight to the investment management industry were based on a false narrative that the financial crisis had been caused by an unregulated shadow banking system that included investment management firms and funds. He said that capital markets were already comprehensively regulated by the SEC and the Commodity Futures Trading Commission (the "CFTC"), and that bank-style oversight of the capital markets (including investment management firms and funds) was not appropriate.

Commissioner Piwowar pointed out that prudential regulation did not, in any event, have a particularly distinguished record in addressing systemic risks in the banking sector. He noted that, before 2008, many large banks had been allowed to become reliant upon short-term borrowing at low rates to fund lending and other operations, and that this over-extension had contributed to the financial crisis. He also noted that the prudential regulators' response to the financial crisis, which has included discouraging banks from providing liquidity in fixed income markets and driving a significant reduction in dealer inventory of fixed income securities, had resulted in a decrease in liquidity in these markets. Investment managers and their funds have stepped in to fill this gap and have provided a measure of liquidity. Commissioner Piwowar found it troubling that, having driven banks largely out of the business of providing liquidity to these markets, banking regulators have concluded that they should now regulate the investment managers and funds that have replaced the banks.

Commissioner Piwowar criticized the efforts of the Financial Stability Oversight Council and the Financial Stability Board ("FSB") to extend their regulatory authority to investment managers and their funds, noting a lack of transparency in decision-making and determinations that do not appear to be based on solid data or analysis. For example, he expressed dissatisfaction with the record on which they had determined that investment managers and their funds should, but pension funds and sovereign wealth funds should not, be subject to their regulation.

Following this defense of the investment management regulatory regime from the depredations of prudential banking regulators, Commissioner Piwowar reviewed three areas of the investment management regulatory regime that he believed did merit review: (i) fund data reporting, (ii) in-kind redemptions, and (iii) temporary suspension of redemptions. Commissioner Piwowar endorsed the SEC's current review of data reporting, noting that additional reporting with respect to such matters as the use of derivatives and securities lending may well be important to support the efforts of the SEC and its staff to identify and evaluate risks in the investment management industry. He suggested that existing quarterly fund portfolio information reporting should be made available in an interactive data format to facilitate analysis by investors, advisers, academics and others.

Commissioner Piwowar observed that the ability to pay redemptions in-kind significantly differentiated mutual funds from banks. He noted that while prudential regulators appeared to believe that mutual funds were as susceptible to a run as banks, the ability to pay redemptions in-kind allowed mutual funds to pay large redemptions without necessarily impacting the market prices of their portfolio investments by selling them to raise cash. He then said that Rule 18f-1 under the 1940 Act, a rule intended to allow mutual funds to limit in-kind redemptions to facilitate mutual fund share sales in jurisdictions where this is required, should be revisited in light of the National Securities Markets Improvement Act of 1996 ("NSMIA," which preempted state registration requirements, such as those limiting in-kind redemptions) and current market conditions.

Commissioner Piwowar noted that Section 22(e) of the 1940 Act allowed the SEC, by rule, to determine conditions under which an emergency allowing an open-end fund to suspend redemptions would be considered to exist. He referred to Rule 22e-3 (allowing the suspension of redemptions by money market funds during liquidation) and suggested that it would be preferable for the SEC to consider whether additional rules under Section 22(e) could be crafted to address concerns about the operations of mutual funds in financial crises, rather than for prudential regulators to designate mutual funds or their advisers as systemically risky and thus subject to bank-like regulation.

General Session — 75 Years and Counting: Building on the Strengths of Investment Company Act Regulation

Moderator: Craig S. Tyle, Executive Vice President and General Counsel, Franklin Templeton Investments

Speakers: Kenneth J. Berman, Partner, Debevoise & Plimpton LLP
Rose F. DiMartino, Partner, Willkie Farr & Gallagher LLP
Andrew J. Donohue, Managing Director and Deputy General Counsel, Goldman, Sachs & Co.
Andrew J. Donohue, Managing Director and Deputy General Counsel, Goldman, Sachs & Co.
Erik R. Sirri, Professor of Finance, Babson College

This panel discussed both the history of the regulation of investment companies under the 1940 Act and recommendations for regulatory change going forward.

Significant Developments. The panelists began by identifying the most significant developments since the passage of the 1940 Act. For Mr. Berman, it was the 1970 amendments, which introduced Sections 15(c) and 36(b), expanded the categories of persons who are "interested persons," and required investment advisers whose only clients were registered investment companies to register as investment advisers. Mr. Donahue preferred the adoption of Rule 12b-1, the addition of Section 2(c) to the 1940 Act (requiring the SEC to consider in its rulemaking, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation), and the introduction of the dual state/SEC system of investment adviser regulation. Mr. Sirri considered Section 36(b) to be the most significant development, and Ms. DiMartino commended Rule 2a-7 (for turning bank depositors into mutual fund investors) and the fund governance standards (Rule 0-1(a)(7), for, among other things, requiring executive sessions). Mr. Berman then commented on the significance to the industry of the market timing and directed brokerage enforcement actions, noting that the SEC had discovered the strength of its enforcement powers under Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act") and had learned that "rule-making through enforcement" was possible. Wrapping up this topic, Mr. Tyle said that he considered the forward pricing rule (Rule 22c-1) to have been a critical development.

The panelists then considered the sources of the 1940 Act's continued vitality. Mr. Donahue noted that, while a principles-based statute, it had generated a large number of rules, explaining that this resulted from numerous statutory provisions in the form of "you cannot do something unless it is permitted by an SEC rule." Ms. DiMartino said that Section 6(c) of the 1940 Act permitted innovation by allowing the SEC to exempt persons, securities, and transactions from provisions of the 1940 Act. She noted that, while the SEC exemptive process should be improved, it was faster to obtain an exemption from the SEC than it was to obtain a statutory amendment from Congress.

Systemic Risk. Turning to the issue of systemic risk, Mr. Sirri said that the SEC was fundamentally ill-suited to oversee it. He said that the SEC as an agency was too focused on law enforcement and under-resourced in terms of economic analysis. He noted that asset managers were the most important financial industry participants not under the supervision of the Federal Reserve, but said that he would prefer that the same regulator be responsible for both financial market risk and investor protection. Ms. DiMartino, perhaps anticipating a concern of the prudential regulators, recommended that money market funds be permitted to delay redemptions in times of market stress until their portfolio investments matured.

Fee Regulation and Board Oversight Issues. The panelists addressed the regulation of fees under the 1940 Act. Mr. Sirri said that funds are both a product (the investor is the purchaser) and a service (the investment adviser is the service provider). He observed that the regulation of investment companies derived in large part from trust law, imposing fiduciary and other duties on the service provider. He said that market forces should adequately address product fees but that, because of concerns about this in the market for investment companies, fees were regulated through the application of Section 36(b) and Rule 12b-1 to the service providers. Mr. Sirri said that he favored a market-based approach to fee regulation, noting as an example that fund directors weren't in a position to set distribution prices, only to decide whether or not to offer the fund. Mr. Berman noted that, in 1970, when Section 36(b) was added to the 1940 Act, the current prospectus fee table disclosure requirements did not exist. He argued that, because of the standardized fee table information, market forces should now be more effective in regulating fees.

Mr. Donahue questioned whether regulation had evolved in ways that place too many specific requirements on fund boards, such as reviewing all cross transactions under Rule 17a-7. He noted the possibility that specific obligations in exemptive rules could be replaced by the more general obligations under Rule 38a-1, but acknowledged that this would involve a large undertaking by the SEC staff. Mr. Sirri said that boards should continue to police the agency problem (the conflict of interest between the investment adviser and fund shareholders) and oversee processes and service providers, but should not have final responsibility for highly technical matters, such as valuation.

Recommendations for Change. The panel concluded with an airing of the panelists' recommendations for change. Mr. Sirri recommended relieving fund directors of responsibility for reviewing and approving distribution fees, because these fees are as a practical matter within the control of broker-dealers, not fund boards. Mr. Donahue sought clarification of director responsibilities in valuation. Ms. DiMartino recommended that intermediaries be required to disclose to their customers all of the money they receive in connection with sales of fund shares. Mr. Berman sought improvements to NSMIA that would prevent challenges to director independence in state court, and make it clear that the only way to challenge fees was under Section 36(b). Mr. Tyle went a step further than Mr. Berman and recommended that Section 36(b) be eliminated. He also recommended that fund directors be allowed to focus on oversight, rather than on relatively minor matters.

General Session — The Regulatory Outlook for Funds and Advisers: Domestic and Foreign Priorities

Moderator: Susan M. Olson, Chief Counsel, ICI Global

Speakers: Diane C. Blizzard, Associate Director, Rulemaking, Division of Investment Management, U.S. Securities and Exchange Commission
Thomas C. Bogle, Partner, Dechert LLP
Phillip S. Gillespie, Executive Vice President and General Counsel, State Street Global Advisors
Christine M. Morgan, Managing Counsel, T. Rowe Price Associates, Inc.

This panel discussed several key securities regulatory themes and priorities for mutual funds and investment advisers, focusing first on a three-part framework of SEC priorities announced by SEC Chair Mary Jo White in a December 11, 2014 speech.

Improving Data and Other Information from Funds and Advisers. Mr. Bogle outlined the filing and disclosure obligations imposed by the SEC on funds and advisers, and noted elements of the SEC disclosure regime that had been criticized by other U.S. regulators: a speech by the Office of Financial Research had noted a need for better information about assets under management, liquidity and leverage; and the FSB had observed a difficulty in getting useful data because funds are primarily regulated from the perspective of investor protection rather than prudential oversight. Ms. Blizzard noted that Form N-MFP for money market funds is the template for new disclosure initiatives for other types of SEC registrants. She observed that the portfolio holdings information filed on Forms N-CSR and N-Q is not currently in a structured format, and said "it would be nice" to get such information more frequently than quarterly. In response to a question, Ms. Blizzard noted that the SEC's rulemaking process could consider allowing registrants to keep confidential any portfolio holdings disclosures that are required more frequently than quarterly. She stated that the lack of a standardized format for disclosure of derivatives is “a clear gap” in the current reporting framework, and that the SEC does not currently receive good information on securities lending practices by funds.

Enhancing Controls on Risks Related to Portfolio Composition. Mr. Bogle commented that funds’ derivatives investing and liquidity controls raise particular concern about risk management. He highlighted recent statements that the SEC may propose requiring funds and advisers to develop a risk program framework, much as the chief compliance officer (“CCO”) rules imposed a requirement for a compliance framework a decade ago. Ms. Blizzard described three interrelated topics that are being reviewed by dedicated working groups at the SEC: (i) liquidity (both market liquidity of fund holdings and liquidity of investors’ shares in funds), (ii) risk management, and (iii) stress testing. She said the SEC staff is seeking to assess how liquidity practices vary across the industry, including with respect to interfund lending and credit facilities. Ms. Blizzard stated that the current goals as the SEC develops its long-awaited derivatives guidance include: (i) providing the OCIE staff with clear directions for their review of derivatives usage during routine examinations and (ii) dictating compliance tests that can be applied consistently over time amid changing market practices. Ms. Blizzard stated that the SEC staff had met with advisers that are currently performing stress testing under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Transition Planning for Investment Advisers. Ms. Blizzard described the SEC staff’s initiative to require investment advisers to create transition plans for the event of a major disruption in their business, similar to the creation of a “living will.” She described the transition planning as a refinement on business continuity plans, and contemplated that elements of the planning would include assessing information technology capabilities, location of critical documents, and custody of client assets. Mr. Gillespie commented that State Street Global Advisors is already subject to regulations requiring a living will and that the process of preparing for a possible disruption or dissolution can be part of “good hygiene” for a business and need not be overly onerous. The panel questioned why transition planning was now a priority for the SEC, and Mr. Gillespie suggested that it was partly to placate the prudential regulators, which approach regulation differently and have increasingly been intersecting with the investment management industry.

Other Important Regulatory Activities Affecting Funds and Advisers. The panel then turned to regulatory initiatives by various regulators. Ms. Morgan described the “dealing commission” restrictions to be imposed in the European Union (“EU”) under the Markets in Financial Instruments Directive II (“MiFID II”) by 2017. She said that the MiFID II restrictions would require advisers either to pay for research out of their own pocket or to agree with each client on a budget for research to be acquired using soft dollars; in effect requiring advisers to assign some price tag to each piece of research. Turning to SEC priorities for 2015, Ms. Blizzard said that money market FAQ’s would be forthcoming, and that the SEC was still working to remove rating agency references from Rule 2a-7. Mr. Bogle highlighted a pending customer due diligence rule from the U.S. anti-money laundering regulator, the Financial Crimes Enforcement Network, expected in 2015, noting it could be complex to implement for mutual funds.

Session 1-A — Current Tax Developments

Moderator: Ryan Lovin, Assistant General Counsel, Investment Company Institute

Speakers: Keith O'Donnell, Managing Partner, ATOZ, Taxand Luxembourg
William M. Paul, Partner, Covington & Burling LLP
Dana Smith, Director of Tax Administration, ALPS Fund Services, Inc.

This panel focused on the current developments in tax regulation that may have an impact on funds.

Tax Legislative Developments. Mr. Paul described as "relatively slim" the prospects for any tax legislation, let alone proposals relating to regulated investment companies ("RICs"), in 2015, notwithstanding that current Ways and Means Committee Chairman Paul Ryan is apparently comfortable with 90% of last year's tax reform discussion draft produced by former Ways and Means Committee Chairman, David Camp, and significant overlap with Obama administration tax proposals.

Included in legislation enacted in December 2014 are: (i) a one-year extension of tax breaks that had expired at the end of 2013 (for taxable years beginning 2013), including flow-through treatment of short-term capital gains and interest-related dividends paid to non-U.S. shareholders, and the treatment of a RIC as a so-called "qualified investment entity" under the Foreign Investment in Real Property Tax Act and (ii) technical corrections to the RIC Modernization Act of 2010.

On the administrative front, the Internal Revenue Service has provided guidance concerning the tax implications of the revised SEC rule pertaining to institutional money market funds with a variable (or "floating") per-share net asset value ("NAV"). This includes proposed regulation permitting shareholders in such a RIC to compute gain and loss on such shares for any period of up to a year, on an inventory-type method, rather than tax lot by tax lot. It also issued a revenue procedure (2014-45) providing complete relief from the "wash sale" rules for variable NAV money market fund shareholders not using the NAV method described above.

Finally, the possible division of existing money market funds into separate retail and variable NAV money market funds raises tax issues: in order to effect a tax-free division under the Internal Revenue Code of 1986, as amended, reorganization provisions, a RIC must meet an "active trade or business" requirement, and regulations except from the definition thereof investing on one's own account. There is at least one self-help alternative to this route, intended to allow a RIC to divide without immediate tax consequence to the RIC or its shareholders; the ICI has requested guidance.

International Tax Issues. Mr. O'Donnell spoke about EU reclaims. He first provided considerable background on the history of European Court of Justice decisions prohibiting EU members from discriminating among EU-member funds (<u>Aberdeen</u>) or non-EU country funds (<u>Santander</u>). He observed that one of the things that has been bothering the various European courts is the fact that the European countries do not feel there is any reciprocity of benefit in respect to these rebate claims vis-à-vis the United States.

Mr. O'Donnell divided EU countries into three groups: (i) countries with final court decisions in favor of non-EU (U.S.) funds – Finland and Sweden, (ii) countries with significant but not final court decisions in favor of non-EU funds – France and Poland, and (iii) other countries, in various earlier stages of the judicial process – Belgium, Spain, Netherlands, Germany, Italy, Austria, Denmark, Norway and Hungary. Notwithstanding the favorable court developments, Mr. O'Donnell expressed the view that the amounts of money involved and the various impediments that certain countries continue to throw in the direction of U.S. mutual funds support the nonaccrual of value in respect of such claims until a particular foreign government either establishes a clear practice of providing substantial refunds to U.S. funds or has made specific undertakings to a particular fund.

Mr. O'Donnell then discussed the proposed EU Foreign Transaction Tax ("FTT"), which he described as a "zombie proposal," as it simply cannot be killed and will not go away. Once again, he divided EU countries into three groups: (i) those with an FTT in place – Belgium, Cyprus, Finland, France, Ireland, Italy, Malta, Poland and the United Kingdom, (ii) those supportive of an EU FTT, including three countries (Belgium, France and Italy) that already have such FTT in place, and eight others – Austria, Estonia, Germany, Greece, Portugal, Slovakia, Slovenia and Spain, and (iii) countries opposed to an EU FTT, also including three countries (Cyprus, Malta and the United Kingdom) that currently have their own FTT in place, and five others – Bulgaria, Czech Republic, Denmark, Luxembourg and Sweden.

Finally, Mr. Lovin described the 10% Chinese capital gain tax applicable to non-Chinese investors, which has been on the books for years. This past November, in connection with the launch of the Shanghai-Hong Kong Stock Connect program, the Chinese Tax Authority issued guidance regarding the retroactive and prospective application of the tax. Among other things, the guidance clarified that China would start to collect a tax on a security sold before a "temporary exemption" came into effect in November 17, 2014.

Session 1-B — Trends in Fee Litigation: Actions Brought Under Section 36(b) and ERISA

Moderator: Julia S. Ulstrup, Vice President and General Counsel, ICI Mutual Insurance Company, RRG

Speakers: Charles A. Etherington, Senior Vice President and General Counsel, American Century Investment Management, Inc.
James O. Fleckner, Partner, Goodwin Procter LLP
Sean M. Murphy, Partner, Milbank, Tweed, Hadley & McCloy LLP

This panel focused on trends in Section 36(b) and ERISA fee litigation.

Basic Legal Framework. Ms. Ulstrup introduced the panelists and the session. Over the years, the plaintiffs' bar has challenged fees charged to mutual funds by investment advisers and other service providers under Section 36(b) of the 1940 Act. Similarly, the plaintiffs' bar has initiated challenges to fees and compensation received by retirement plan service providers by alleging violations of various provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). In both instances, the litigation is almost always part of a group of suits across the industry brought by the plaintiffs' bar and not instigated by any particular aggrieved individual plan participant or shareholder.

Mr. Fleckner explained that ERISA imposes fiduciary obligations on people who have discretionary responsibility or control of a plan or plan assets. The fiduciary duty of prudence is most relevant for fee litigation. A plan should be administered in a way that a prudent person, under like circumstances, would manage a like enterprise. In ERISA-based fee litigation there are typically two types of plaintiffs: (i) participants or beneficiaries and (ii) the trustees or the named fiduciaries of smaller plans bringing suit on behalf of their plans against the service providers.

Mr. Murphy noted that Section 36(b) imposes a fiduciary duty on fund investment advisers with respect to the receipt of compensation. In Section 36(b) litigation, the plaintiffs are shareholders of funds bringing suit against the fund adviser. The courts have said that there can be a breach of fiduciary duty with respect to the receipt of compensation when a fee is so disproportionate to the services rendered that it could not have been the product of arm's length bargaining. The courts look to several factors, discussed in the 1981 *Gartenberg* case and reiterated recently in *Jones v. Harris*, to assess whether a fee is disproportionate.

Trends in Litigation. Mr. Murphy observed that there have been two waves of Section 36(b) litigation in the past several years. In the more recent wave of Section 36(b) lawsuits, beginning around 2010, the plaintiffs' bar typically alleges that funds with some form of sub-advisory arrangement are being charged excessive fees because their advisers (as the managers of managers) are collecting advisory fees, but delegating virtually all of the substantive advisory work to the sub-advisers. There is also a recycled theory from the prior wave of Section 36(b) lawsuits, commonly referred to as the “reverse manager of managers” theory. Under this theory, plaintiffs claim that advisory fees charged to mutual funds are excessive because the advisers charge lower fees for institutional products. In this current wave of suits, plaintiffs are alleging that the adviser is charging a lower fee to sub-advise funds with a similar strategy, while ignoring the fact that comparing advisory fees and sub-advisory fees is an apples-to-oranges comparison.

Mr. Fleckner explained that there has been an uptick in ERISA cases because of the proliferation of 401(k) plans. Recently, the plaintiffs’ bar has brought ERISA lawsuits attacking the fee structures of funds offered as investments under retirement plans. The plaintiffs’ bar has attacked fee structures that include revenue sharing with the record keeper as excessive or claimed that the fund’s administrative fees are excessive.

Key Stages in Litigation. The panelists agreed that Section 36(b) and ERISA lawsuits are typically long and expensive cases both to prosecute and defend. The major stages of litigation in these cases are: (i) motion to dismiss, (ii) summary judgment, and (iii) trial.

Historically, most cases settle before trial, but Mr. Murphy observed that many Section 36(b) cases have survived past the motion-to-dismiss phase. Expert discovery takes place after the motion-to-dismiss phase and before summary judgment. Defendants are often better able to understand the plaintiffs’ case after expert discovery. Since most cases settle, there are only a few 36(b) summary judgment decisions (the *Jones v. Harris* case before the U.S. Supreme Court was a summary judgment case in favor of the adviser). If the case does make it to trial, given the high standard for 36(b) liability dictated by the Supreme Court, defendants are more likely to prevail, and, in fact, plaintiffs have never won a Section 36(b) case at trial.

Mr. Fleckner noted that, procedurally, ERISA cases are usually brought as class actions, while Section 36(b) cases are brought as derivative suits. An ERISA defendant can resolve an ERISA case by successfully opposing class certification. Also, because of class certification, the settlement amounts in ERISA cases are public. By contrast, Section 36(b) settlements are usually not public because, unlike class actions, there is no requirement to obtain court approval of a 36(b) settlement. Some settlements in ERISA cases have been large, and when ERISA cases do make it to trial, plaintiffs often have been able to obtain at least some form of relief.

Predictions for the Future. Mr. Murphy said that there are many active Section 36(b) cases in various stages of litigation. He noted that the plaintiffs’ firms bringing the cases are small firms with limited resources and predicted they may be at capacity and unlikely to bring many more cases. Mr. Fleckner noted that for the first time an excessive fee ERISA case is in front of the U.S. Supreme Court on the merits (*Tibble v. Edison International*) and that this will be a noteworthy decision. Mr. Fleckner predicted that there will be more ERISA cases as compared to Section 36(b) cases going forward because the standards in ERISA cases are less well-defined and settlements have emboldened plaintiffs' lawyers.

Session 1-C — Best Execution and Trading Compliance Across Asset Classes: Addressing Portfolio Management Concerns

Moderator: Ari Burstein, Associate General Counsel, Investment Company Institute

Speakers: Scott R. Burrill, Partner and Managing Director, Rosenblatt Securities Inc.
Michael S. Caccese, Partner, K&L Gates LLP
Jon Kroeper, Senior Vice President, Market Regulation Department, FINRA
Michael L. Post, General Counsel, Regulatory Affairs, MSRB
Timothy J. Stark, Market and Transaction Research, The Capital Group Companies

This panel focused on the challenges advisers face and processes advisers use in evaluating and measuring best execution in today's markets.

Introduction. Mr. Caccese explained that best execution is not a statutory requirement; rather it arises because registered investment advisers are fiduciaries and, therefore, have a common law duty to seek best execution for all securities transactions for their clients. He explained that price is an important factor in evaluating best execution, but there are other important factors, such as the value of research provided by the broker and the ability of the broker to work the trade while preserving anonymity.

Mr. Burrill said that "electronification" (*e.g.*, high frequency trading) and fragmentation of trading across venues have led to reduced average order sizes from roughly 1,200 shares to approximately 200 shares per trade, while asset flows have not declined. He noted that the trade volume in dark pools for some stocks, like Apple, is as high as approximately 40% of total trading volume and that off-exchange trade volumes generally significantly exceed exchange trading volume except when volatility significantly increases. He said that institutional transaction costs have declined since 1994, while modern market developments, including the growth of high frequency traders, have taken hold.

Transaction Cost Analyses. Mr. Stark said that Transaction Cost Analyses ("TCAs") alone are not sufficient to tell the entire execution story and that best execution and trading oversight committee members need to understand the context for trading patterns and why certain venues or broker-dealers are being used. For example, large trades often require brokers to implement a multi-day trading strategy, which is not captured in a TCA.

Mr. Post noted that, under the upcoming SEC-approved final rule regarding municipal securities, if a firm follows a reasonable process and it is later determined that there was a better price in the market, the existence of a better price will not imply a violation of Municipal Securities Rulemaking Board requirements.

Panelists agreed that resource-constrained smaller asset management firms face greater challenges generating TCAs. The consensus of the panelists was that such firms still need to implement best execution policies and procedures, understand the different trading options that are available to them and do some price testing (even if it involves a less sophisticated analysis). Such firms can also consider partnering with a commercial TCA firm.

Trade Data Collection. Mr. Burstein noted that the ICI had created and submitted to the SEC a template for brokers to use to provide information to asset management firms to assist the buy-side with monitoring trade routing and order execution, and that the ICI is optimistic about the SEC adopting a rule that will aid institutional investors in obtaining this kind of information from broker-dealers.

Mr. Kroeper reported that the Financial Industry Regulatory Authority (“FINRA”) is now able to capture cradle-to-grave data on over 99% of trading volume and that FIRNA is now the second largest Amazon cloud data storage customer.

Other Issues. Mr. Caccese discussed the need for advisers to oversee sub-advisers’ best execution practices and for advisers and sub-advisers to clearly understand how best execution roles and responsibilities are divided among them.

Panelists discussed trends in regulation of soft dollars, noting the uncertainty in the United Kingdom and elsewhere in Europe about whether complete unbundling will take hold and the significant challenges that could emerge for firms if Europe and the United States adopt divergent models to pay for research.

Mr. Caccese highlighted issues that arise when trades for one selling client and one buying client are netted through a broker. He reported that these transactions might be viewed by regulators as cross-trades. He said that the industry is seeking to address this by presenting the net trade to the broker and getting a commitment from the broker to honor the quoted prices even if one leg of the trade is broken, supporting an argument that the transaction should not be viewed as a cross-trade.

Session 1-D — Future of ETFs: Is it California Dreamin’?

Moderator: Jane G. Heinrichs, Associate General Counsel, Investment Company Institute

Speakers: Shelly Antoniewicz, Senior Economist, Investment Company Institute
Dalia Osman Blass, Assistant Chief Counsel, Division of Investment Management, U.S. Securities and Exchange Commission
Ryan Louvar, General Counsel, WisdomTree Asset Management, Inc.
W. John McGuire, Partner, Morgan, Lewis & Bockius LLP

The panel discussed the increasing popularity of exchange traded funds ("ETFs") and made various observations regarding exemptive relief and financial stability concerns with respect to ETFs.

Growth of ETFs. Ms. Antoniewicz reviewed data regarding the tremendous growth experienced by ETFs, noting that net ETF inflows for 2014 were approximately 2.5 times net inflows into traditional mutual funds. She explained that while the substantial majority of ETF assets (approximately $1.4 trillion) are in traditional capitalization-weighted indices, strategic beta and other index ETFs represent more than $400 billion, and actively managed ETFs represent only $14 billion.

Mr. Louvar commented on the expansion of the ETF investor base, noting that financial advisers are increasingly using ETFs to build the core of their clients' portfolios. He observed that self-directed investors also seem to be increasingly familiar and comfortable with ETFs.

Exemptive relief. Ms. Blass reviewed the ETF exemptive application process, noting that the processing of routine exemptive applications has been significantly expedited by the streamlining of applications and consolidation of relief (routine passive ETF applications now typically cover master-feeders, affiliated index providers and unaffiliated index providers). She reported that routine applications are typically granted in six months, but some applications have taken as little as six weeks. Ms. Blass also noted that it is particularly helpful when applicants filing more novel applications include letters and blacklines highlighting the differences between their application and recent routine applications.

Mr. McGuire noted that the SEC's Division of Trading and Markets has issued no-action letters and class relief for many ETFs under the Securities Exchange Act of 1934 (the "1934 Act") that generally permits brokers to treat ETF shares like other listed equities. He explained that Rule 19b-4 applications were still necessary for actively managed ETFs and other ETFs that don't meet the generic listing standards, and noted that the New York Stock Exchange had recently filed proposed listing standards for actively managed ETFs, which would significantly reduce the time required to launch most actively managed ETFs. Ms. Blass noted that, for ETFs requiring a Rule 19b-4 application or other 1934 Act relief, it is helpful to request relief from the Division of Investment Management and the Division of Trading and Markets simultaneously.

Mr. McGuire noted that although the SEC lifted its moratorium on exemptive relief for ETFs that use derivatives in 2012, actively managed ETFs are, through the Rule 19b-4 application process, still subjected to restrictions on their ability to use derivatives. Ms. Blass stated that any concerns regarding the use of derivatives are no different for ETFs than for traditional funds.

Mr. McGuire noted that several exemptive applications had been filed, and two denied, that sought to use a blind trust structure or a proxy portfolio to avoid daily transparency of the ETFs' portfolio holdings. He reported that one of the denied applications has already been re-filed. Mr. McGuire noted that the SEC had approved an exemptive application filed by Eaton Vance for exchange traded managed funds ("ETMFs"). Ms. Blass explained the features of the ETMF application that had led to its approval by the SEC.

Mr. McGuire explained that older ETF orders were not as specific as current ETF orders about how similar an ETF's purchase and redemption baskets need to be to a pro rata slice of the ETF's portfolio. Ms. Blass explained that the main concern of the SEC staff is whether an authorized participant (an "AP") might be able to cause the ETF to change the custom basket in ways that benefit the AP.

The panel discussed the desirability of adopting an exemptive rule to eliminate the need for routine exemptive applications. Ms. Blass stated that while adoption of an ETF rule is still technically on the SEC's agenda, the SEC currently has a significant number of other high-priority initiatives.

ETFs' Impact on Financial Stability. Ms. Antoniewicz reviewed the argument that ETFs might lead to financial stability concerns. She explained that secondary market trades in ETF shares do not necessarily generate trading in the ETF's underlying portfolio securities. She also reported that the vast majority of trading in ETF shares was on the secondary market, rather than between ETFs and APs. Ms. Antoniewicz explained that, contrary to misconceptions in the press and by certain foreign regulators, liquidity in ETF shares does not depend solely on APs. She noted that when Knight Capital ceased operating as an AP, there was no impact for larger ETFs, and only a modest impact for smaller ETFs, as other liquidity providers entered the market. Finally, Ms. Antoniewicz noted that, even during the "taper tantrum," bond ETFs didn't experience significant redemptions. Ms. Blass reported that the SEC's Division of Economic and Risk Analysis is looking to catalog research involving ETFs and looking for empirical evidence to support or contradict these concerns.

Session 2-A — Hot Topics and Challenging Issues for Fund Boards: Independent Counsel Roundtable

Moderator: Amy B. R. Lancellotta, Managing Director, Independent Directors Council

Speakers: Marguerite C. Bateman, Partner, Schiff Hardin LLP
David A. Hearth, Partner, Paul Hastings LLP
Bruce G. Leto, Partner, Stradley Ronon Stevens & Young, LLP

Intermediary Oversight. Mr. Hearth discussed the SEC's ongoing scrutiny of whether fund payments to intermediaries for sub-recordkeeping services represent payment for "distribution in guise." He noted that fund boards should understand the nature of the services provided by the funds' intermediaries and the adviser's conflicts with respect to payments by funds to intermediaries, and stressed that boards must receive sufficient information to evaluate the reasonableness of fees paid by the funds. The panelists debated whether boards should receive information regarding sub-recordkeeping payments and adviser revenue sharing payments in the same report, and Mr. Leto suggested that boards may not want that information as part of a single report so as to avoid blurring lines between sub-recordkeeping and distribution-related services. Ms. Bateman noted that she does not recommend overhauling boards' current approach to reviewing payments to intermediaries until the industry receives further guidance in this area.

Alternative Investment Funds. Ms. Bateman stressed the importance of early and frequent board education regarding alternative funds. Mr. Leto discussed the importance of good, clear prospectus disclosure for alternative funds, and noted that boards often rely heavily on counsel to develop this disclosure. Mr. Hearth observed that alternative funds often lack good, comparable peer groups against which to benchmark fees and performance.

Fair Valuation. Mr. Leto reviewed the valuation guidance included in the SEC's recent money market funds release. He noted that the guidance stressed the non-delegable nature of certain valuation-related functions, and that boards need to understand the adviser's due diligence on pricing services. He also recommended that any changes to a fund's pricing services be approved by the board. The panelists discussed whether some sort of board action is appropriate with respect to fair value prices determined by the adviser, and Mr. Leto recommended that fund boards ratify such valuations in some manner (*e.g.*, ratify such valuations as having been "effected in accordance with the funds' procedures").

Cybersecurity. Mr. Leto suggested that boards conduct an annual review of cybersecurity issues, possibly as part of the board's 15(c) process. He noted that whether a particular cyber breach constitutes a breach of a service provider's standard of care depends on the facts at issue. Mr. Hearth noted that as industry practices evolve, the effective standard of care set forth in fund agreements (*e.g.*, imposing liability where the service provider is negligent) is likely to evolve to reflect changing industry standards even if fund agreements are not amended. Ms. Bateman observed that adviser and board interests are generally aligned on cybersecurity issues. The panelists discussed whether fund boards were seeking cyber experts as part of new director searches, and agreed that they were not observing that to be the case.

SEC Senior Level Engagement. Ms. Lancellotta noted that senior SEC staff members had requested a number of meetings with advisory firm senior management and fund boards in recent months. Ms. Bateman noted that questions she had heard were being asked as part of these meetings included whether fund directors are overextended, whether director responsibilities are appropriately allocated, whether directors oversee too many funds, and whether directors are equipped to ask tough questions and make tough decisions.

Governance topics. Mr. Hearth commented regarding some boards' expanding use of committees. He noted that it was a good practice for the committee chair or counsel to report out on the topics discussed at the committee level so as to ensure that the full board is well informed and that the results of any discussions are memorialized in the funds' minutes. Ms. Bateman stressed the importance of memorializing board discussions and resolutions of compliance issues. Mr. Hearth noted that many boards find it useful to conduct a skill assessment of different subject areas to identify areas of need when looking for director candidates, and noted that candidates with specific skills tend to attract more interest than generalist candidates.

Questions. The panelists were asked to identify one area of board oversight where they would change the current legal framework regarding board responsibilities if given the chance. All three panelists selected valuation, and Ms. Lancellotta selected payments to intermediaries and distribution fees.

Session 2-B — The Regulation of Retirement Products and Services: The Rules They Are A-Changin'

Moderator: Lisa Hund Lattan, Partner, Utz & Lattan, LLC

Speakers: Jon W. Breyfogle, Principal, Groom Law Group, Chartered
Krista M. D'Aloia, Vice President and Associate General Counsel, Fidelity Investments
Robert J. Doyle, Vice President, Government Affairs, Prudential Financial

This panel discussed current regulatory and enforcement initiatives that would have an impact on retirement products and services.

Fiduciary Rule Proposal. Mr. Breyfogle summarized the status of regulations proposed by the Department of Labor ("DOL") that are expected to redefine and significantly expand the categories of persons treated as "fiduciaries" under ERISA by reason of providing "investment advice" for a fee or other compensation with respect to plan assets. In 2011, the DOL withdrew regulations it had originally proposed in 2010, after much criticism from the financial services industry and comments from Congress. Mr. Breyfogle noted that the DOL anticipates reissuing the proposed regulations in the coming months – President Obama announced his support for the new (as yet unpublished) regulations on February 23, 2015, and on the same day the DOL sent its proposal to the Office of Management and Budget ("OMB") for review. The OMB has up to 90 days to review the proposal. The panelists expect the reissued regulations to be similar in form to the 2011 proposed regulations, but with a more robust cost analysis, application to IRAs, and "repackaged" class exemptions. In particular, the DOL has signaled the inclusion of a broader exemption for investment education materials and the addition of a principles-based exemption based on the applicable service-provider meeting a "best efforts" standard and certain procedural requirements. The panelists believe this may signal the use of more "innovative" exemptions to balance the need for certainty in the definition of fiduciary with the need for flexibility for those potentially affected.

Fiduciary Regulation With Respect to IRAs. Ms. D'Aloia discussed existing rules as well as government agency recommendations affecting the provision of advice with respect to IRA rollovers. Both the DOL and the Government Accountability Office ("GAO") have expressed concern that retirement plan participants are not adequately protected from advisers that may put their own interests ahead of those of the participants. The GAO recommended that the DOL include in its fiduciary regulations requirements regarding the provision of IRA rollover advice and disclosure of the adviser's financial interest in IRA rollovers. The panelists also noted that the DOL's new fiduciary rule might provide an opportunity to harmonize the DOL's approach to IRA rollovers with the approach taken by FINRA in a 2013 notice to members.

Fee Disclosure. The panelists provided an update on regulations governing disclosure of service provider fees. The DOL proposed a regulation in March 2014 that would require service providers to provide a guide or summary disclosure document if the current fee disclosures are too long (to be defined) or the plan fiduciary is required to look in too many places. The financial services industry has historically resisted such guide or summary requirements, citing technological and other limitations. The panelists also noted that they expect the DOL to provide permanent relief with respect to the timing of annual fee disclosures to plan participants under ERISA rule 404a-5, which would provide additional flexibility to combine such disclosures with other required disclosures. (This relief was issued on March 19.) Finally, the panelists described a new SEC no-action letter dated February 18, 2015, which extends to non-ERISA 403(b) plans and governmental plans the SEC's position treating investment related information required under ERISA rule 404a-5 as satisfying Rule 482 under the Securities Act of 1933.

Target Date Funds. The panelists discussed recent rulemaking activity with respect to target date funds. Since the DOL issued proposed regulations in 2010, the DOL and SEC have been working to coordinate disclosure regulations applicable to target date funds. In late 2013, an SEC advisory committee recommended that the SEC develop a glide path illustration based on a standardized measure of a fund's risk. The consensus of the panelists was that such a requirement could confuse participants if there is no other risk-based information for comparison. The SEC reopened the comment period for such regulations in April 2014, with comments due in June 2014. The panelists noted that it may be quite a while before any rules are finalized.

DOL Investigations. Mr. Doyle discussed recent trends in DOL investigations. He noted that the DOL now seems to be using investigations to effect its regulatory agenda with respect to financial services organizations. Historically, DOL investigations focused on individual plans – in 2013 the DOL announced a new priority to look at financial institutions, including registered investment advisers, banks and broker-dealers. Such investigations focus on the receipt of improper or undisclosed compensation, use of proprietary products and compliance with prohibited transaction exemptions and fee disclosure requirements. Mr. Doyle further noted that these actions have extracted many settlements, as financial institutions are reluctant to litigate.

Session 2-C — Fund Investment Strategies Using Derivatives: Regulatory and Compliance Considerations

Moderator: Sarah A. Bessin, Associate General Counsel, Investment Company Institute

Speakers: Brendan R. Kalb, Managing Director and General Counsel, AQR Capital Management LLC

Mark D. Perlow, Partner, K&L Gates LLP

Michelle Rosenberg, Vice President, Assistant General Counsel, Janus Capital Management LLC

W. Danforth Townley, Attorney Fellow, Division of Investment Management, U.S. Securities and Exchange Commission

This panel discussed issues facing registered funds that employ derivatives, including effective portfolio management and compliance concerns, as well as accounting, valuation and custody issues and risk-related controls.

Effective Portfolio Management and Compliance. Mr. Kalb began the panel by outlining the many ways in which portfolio managers may use derivative instruments to optimize a portfolio, including equitizing cash, efficiently adjusting a portfolio's duration, hedging an exposure, substituting for direct exposure where direct exposure cannot be achieved in a cost-effective manner, and achieving investment leverage. Mr. Kalb stated that a constant focus of managing the use of derivatives should be counterparty risk. He noted that his firm runs daily credit tests on counterparties and has formed a credit committee that meets weekly to review the firm's counterparty exposures. Mr. Kalb noted that registered funds' practice of maintaining collateral in a tri-party account maintained with a fund's custodian helps to mitigate counterparty risk. He noted that his firm has begun to use tri-party arrangements even for the firm's private funds because the practice protects those funds and aids the firm's risk oversight efforts. He stated, however, that the use of tri-party arrangements for private funds may not be practical in all circumstances.

Ms. Rosenberg stressed the importance of each portfolio management team having the investment expertise to understand its derivative trading, not only at the fund level, but also at the complex-wide level. Ms. Rosenberg noted that an important part of her team's process is reviewing trade documentation on an instrument-by-instrument basis and ensuring the adviser has the authority to trade the instrument while also having in place the appropriate disclosure to investors regarding the use of the instrument. She noted the complexity in trading over-the-counter instruments as each may have a unique collateral schedule regarding bespoke mark-to-market arrangements. She noted also that compliance professionals have to evaluate the appropriate asset segregation scheme for each instrument and be able to analyze each instrument's effect on a fund's ability to meet its concentration, diversification, and names rule policies while also, where applicable, maintaining intra-day compliance with any CFTC exemptions.

Accounting and Valuation. Mr. Perlow commented on the difficult issues that arise in accounting for derivative instruments, noting that a firm's accounting system needs to track all of the frequent payments associated with daily mark-to-market arrangements.

Mr. Perlow noted that the SEC staff stopped issuing no-action relief in respect of asset segregation schemes under Section 18 of the 1940 Act about 20 years ago and that asset segregation practice now develops mostly through the SEC staff's comments in the disclosure review process. Mr. Perlow also commented on the difficulty in valuing over-the-counter derivative instruments, noting the importance of understanding and testing the methodologies of quotation providers and suggesting that the use of counterparty quotations be paired with a robust back-testing scheme.

Disclosure. Mr. Townley discussed the SEC staff's 2010 guidance regarding the importance of tailored disclosure with respect to the use of derivative instruments. He noted, however, that he understood that registrants' desire for comprehensive disclosure regarding the use and risks of derivative instruments means that tailored disclosure may not be practical. In response to a question from the audience, Mr. Townley confirmed that the SEC staff was evaluating the different asset segregation schemes for physically-settled and cash-settled derivative instruments that have developed. He said he understood that many registrants believe the investment exposures provided by cash-settled and physically-settled instruments are the same or substantially identical and that there is not a justification for the highly differentiated asset segregation requirements for the trades. During the discussion that followed, the panel noted the hope that the SEC staff would incorporate industry feedback that was provided in connection with the SEC's 2011 concept release into the SEC's 2015 rule-making initiatives regarding stress testing and liquidity management.

Custody Issues. The panel then discussed custody issues associated with the posting of collateral by registered funds. Mr. Perlow commented that posted collateral remains a fund asset that must be maintained by the fund in accordance with Section 17(f) of the 1940 Act. Mr. Perlow noted that tri-party arrangements may be preferable in certain respects to the custody arrangements that have developed for futures transactions effected through a futures commission merchant because, in those cases, a fund's assets may be commingled with the assets of other clients of the futures commission merchant.

Mr. Townley commented on the recent SEC enforcement action against Water Island Capital LLC. He noted that one might view that enforcement action as a reminder to new entrants to the registered space that just because fund assets remain within a regulated space (*i.e.*, in the custody of a broker-dealer), that fact alone may not satisfy the much more stringent framework of the 1940 Act. The other panelists commented that the case was also symbolic of the SEC staff's heightened interest in the use of derivative instruments by managers in the "liquid alternatives" portion of the industry who may not be as familiar with the practices of registered investment companies. Mr. Perlow also commented that the broker-dealer community frequently cites some admittedly vague language in the Robertson Stephens no-action letter relating to short sale positions for the proposition that certain assets, such as the proceeds of short sales, need not be maintained by a fund's custodian. He noted that, in that regard, some divergence of practice has developed.

Risk-Related Controls. The panel then turned to a discussion of risk-related controls. Some panelists noted the benefit of forming a complex products committee that would provide comprehensive oversight of disclosure related to derivative instruments, the negotiation and review of trading documentation, obtaining necessary board approvals, and overseeing the integration of the firm's trading and compliance systems with each other. Mr. Perlow commented that fund boards can continue to play an important role in the oversight of such instruments by being proactive with board education, incorporating derivative instruments into the firm's overall risk management report, and developing tailored reporting, including reporting related to the risks relevant to the funds they oversee.

General Session — U.S. and Global Trends in the Regulation of Payments to Intermediaries

Moderator: David W. Blass, General Counsel, Investment Company Institute

Speakers: Bella Caridade-Ferreira, CEO, Fundscape
Frank J. Nasta, Managing Director, Head of JPMorgan Funds Management Legal, J.P. Morgan Asset Management
Gregory D. Sheehan, Partner, Ropes & Gray LLP
John M. Zerr, General Counsel, U.S. Retail, Invesco Advisers, Inc.

This panel discussed trends in the regulation of payments to fund intermediaries, with a particular focus on the SEC's ongoing scrutiny of whether fund payments to intermediaries for sub-recordkeeping services are distribution payments in guise.

Core Principles/Regulatory History. Mr. Sheehan reviewed the core principles and regulatory history of Rule 12b-1 under the 1940 Act. He noted that Rule 12b-1 prohibits a fund from engaging "directly or indirectly" in financing any activity which is primarily intended to result in the sale of its shares, except pursuant to a Rule 12b-1 plan. He stressed the importance of the Rule's standard for requiring payments to be made under a Rule 12b-1 plan, noting that "primarily intended" is a markedly higher threshold than "may have some potential effect" or "may enhance." He discussed the industry trend of an increasing share of fund assets being held in omnibus form, and noted that, as a result, intermediaries (rather than the fund and its direct service providers) provide many services to fund shareholders. Mr. Sheehan observed that these services are substantial, and that intermediaries must cover the cost of these services.

Mr. Sheehan noted that the SEC staff's 1998 "supermarkets letter" provided that fund boards could determine the portions of a supermarket fee that are paid for distribution and non-distribution services, and reaffirmed Rule 12b-1's "primarily intended" standard. He noted that some SEC staff members appear to believe that sub-accounting payments by funds to intermediaries that provide services with *any* distribution benefits (no matter how limited) are too large in relation to the value of non-distribution services, or are *per se* inappropriate, and that senior SEC staff members have indicated that the SEC likely will bring one or more enforcement actions in the near future.

Mr. Nasta stressed that regulation through enforcement is not an appropriate way to regulate, especially when the target – in this case, payments by funds to intermediaries – is a key part of the industry's infrastructure. He noted that no changes to the current framework should be made without a full, fair and open discussion involving all interested parties, including regulators, funds, transfer agents and intermediaries.

Migration to Omnibus Accounts. Mr. Zerr noted the migration to omnibus accounts at his firm. He stated that whereas over 80% of his firm's fund assets were held in "direct accounts" maintained without an intermediary at the funds' transfer agent during the 1980s, that number had fallen to approximately 50% by the end of 2008, and today represented just 17%.

Mr. Nasta noted that his firm had experienced a similar migration. He observed that the increase in omnibus accounts maintained through intermediaries has provided a number of benefits to fund shareholders, including consolidated statements showing holdings across fund families.

Firm Practices for Evaluating Intermediary Services. Mr. Zerr noted that while requests from intermediaries to transition accounts to an omnibus arrangement often start with the intermediary contacting his firm's sales team, upon receiving a request, the firm's transfer agent services group leads the evaluation of the proposed services and applies a board-approved framework to evaluate the amount of fees to be borne by the funds. He noted that the evaluation process also includes senior management and the firm's legal and compliance groups. Mr. Zerr noted that the fund board looks at a number of factors, including the transfer agent's charges for providing the same services directly, industry data regarding fees charged by other transfer agents, the impact on fund expenses of the transition to omnibus, and the transfer agent's ability to service omnibus accounts.

Mr. Nasta indicated that his firm follows a similar process for evaluating intermediary services, utilizing a cross-functional group to review payments that includes the firm's chief operating officer and representatives from legal, compliance, fund administration and sales. He noted that the fund board receives a comprehensive annual report on all payments to intermediaries, and receives quarterly reports on any changes to the funds' arrangements.

Mr. Blass reviewed industry data regarding transfer agency fees paid by funds over time. He noted that the overall trends show that transfer agency fees have been stable through time, whether measured in basis points or per account charges, and that when adjusted for inflation, there is a downward trend in transfer agency fees. Mr. Zerr commented regarding the increasing range and quality of services provided over time.

Global Perspective. Ms. Caridade-Ferreira cautioned that new regulation often changes the competitive landscape in unexpected ways. She noted that in the United Kingdom, regulators have focused in recent years on "advice fees," and that as a result of new rules put into place at the end of 2013, advice fees must be paid by the customer. She noted that whereas previously, larger accounts were effectively subsidizing smaller accounts, smaller shareholders are now bearing higher costs. She indicated that while UK regulators had intended to bring advice to the entire market, the new regulation had actually triggered a growing "advice gap" in the United Kingdom. She noted that the new regulations had also made it harder for smaller managers to compete with larger managers.

Questions. In response to a question regarding the application of the supermarkets letter to unbundled fees, Mr. Sheehan indicated that the core principles set forth in the letter continue to be valid, and that in some cases it may be easier to apply these principles to unbundled contracts and payment streams than to bundled fees. In response to another question, Mr. Zerr noted that each year, the fund board at his firm looks at every intermediary arrangement, including all payments to a particular intermediary. Mr. Sheehan noted that he thought it was helpful for a board to see all payments to fund intermediaries presented in a single report, as this provides the board with a full picture of all payments to a given intermediary. Mr. Nasta addressed a question regarding trends in intermediary oversight, observing that many firms have cross-functional teams reviewing intermediary services, and that the development of the Financial Intermediary Controls and Compliance Assessment, or FICCA, report has served to facilitate intermediary oversight.

In response to a final question, Mr. Blass stressed he absolutely is not suggesting that the SEC was aware of inappropriate practices for many years but turned a "blind eye." To the contrary, he believes that general practices in this area, including those described by the panelists, are sound. He noted that if the SEC believes the industry is following inappropriate policies and practices with respect to payments to intermediaries, it should engage in a transparent, inclusive process to seek to move the industry to policies and practices that it believes are appropriate.

Session 3-A — Cybersecurity: There Is No Bat Phone!

Moderator: Peter G. Salmon, Senior Director, Operations and Technology, Investment Company Institute

Speakers: Allan Carey, Vice President, PhishMe
Mark Fowler, Vice President, Information Technology and Facilities, Forward Funds
Ellen Rinaldi, Principal, Enterprise Security, Vanguard

This panel discussed cybersecurity issues and offered tips and examples of the ways firms are building their cybersecurity programs and awareness.

The panel noted that cyber threats extend beyond potential breaches of personal information, and include threats to all facets of business, including potential access to a firm's trading algorithms or impersonation of firm personnel in order to authorize the transfer of money. Mr. Carey noted that the effects of cyber attacks should not be viewed as a rounding error – they can have a significant effect on the bottom line.

Cyber Statistics. The panelists noted that the types of cybersecurity attacks continue to evolve, but that the means by which attackers access networks are surprisingly unsophisticated and have not changed to the same extent. For example, employees continue to be the most-cited vulnerability, whether due to lost devices, spear phishing or otherwise. In addition, the panelists cited a statistic that the average time to detect a breach remains very long – over six months (205 days).

Educating Employees. The panelists shared a variety of examples about the means by which their firms are tackling cybersecurity-related issues. In particular, the panelists stressed the importance of educating employees regarding cybersecurity issues. Examples provided by the panelists included: (i) initial and ongoing training/reinforcement through webinars and brown bag sessions, (ii) annual certification of review of information security policies, and (iii) spear phishing training campaigns. Mr. Fowler noted that, during training sessions, Forward Funds shows employees the means by which cyber attacks occur, including the actual emails that have been received by the firm that would allow hackers to penetrate the firm's systems. In addition, the panelists described some of the efforts firms are making to educate employees regarding spear phishing, noting that it is very important for employees to be constantly vigilant before clicking on links in emails. For example, Ms. Rinaldi stated that Vanguard sends spear phishing emails to senior employees that have been personalized – using publicly available information about the recipient, frequently gleaned from social media – to make the spear phishing email appear authentic and relevant to the recipient. Mr. Carey noted that cybercriminals engage in significant social media investigation before spear phishing, and encouraged those involved in overseeing a firm's cybersecurity efforts to engage in web surfing themselves to get a sense of how easy it is for cybercriminals to create a profile of senior level employees. The panelists cautioned, however, that prior to engaging in a spear phishing training exercise that references a particular brand or partner, it is important to ensure that all relevant parties are apprised of the initiative in order to avoid confusion and potential upset.

Surveillance. The panelists described surveillance activities that are intended to help their firms identify or stop potential cyber breaches, including: (i) monitoring employees' downloading activity, (ii) heightened monitoring of employees who are systems administrators (and of the employees charged with monitoring the systems administrators), (iii) web surfing for references to their firms, in particular by employees, (iv) identifying and taking down websites posing as the firm's website, (v) notifications if an employee sends an email to a known dangerous site or gets tricked by a spear phishing training exercise (the latter of which results in immediate education), and (vi) tagging all external emails (including those that are phishing attacks set up to resemble emails coming from an internal email address).

Vendor Oversight. Regarding vendor oversight, the panelists identified the following practices: (i) extensive initial and on-going due diligence (ranging from monthly to annual), (ii) continual monitoring for unusual activity through any network connection with a third party, (iii) diligence regarding fourth-party service providers (*i.e.*, service providers to service providers), and (iv) establishment of a plan/protocol between the parties in the event of a breach. Examples of on-going diligence included monthly conversations with certain third-party service providers regarding changes to their technology, employee turnover and hiring, and any other relevant issues, or use of an annual questionnaire.

Cyber Resources. Mr. Salmon noted that the ICI has created a network for chief information security officers ("CISOs") called the Chief Information Security Office Advisory Committee, which is intended to allow CISOs to maintain contact with peers regarding cybersecurity-related issues. He encouraged all CISOs to join the Committee and stated that the Committee is developing a benchmarking security survey that is intended to provide the Committee with a picture of the industry's current security posture in order to help direct the efforts of the Committee appropriately. He noted that there are helpful resources on cybersecurity-related issues at www.ici.org/ops/ops_resources.

Session 3-B — Accounting and Auditing: What's Next?

Moderator: Brian Wixted, Senior Vice President and Treasurer, OppenheimerFunds, Inc.

Speakers: Brent Oswald, Partner, KPMG LLP
Richard Sennett, Managing Director, Legg Mason
Brian Sweet, Associate Director, PCAOB

This panel focused on several areas relating to fund auditing and accounting matters, including Public Company Accounting Oversight Board ("PCAOB") inspections and examinations, disclosure matters and valuation guidance.

PCAOB Inspections and Examinations. Mr. Sweet reported that issuer audits are largely selected for examination using an analysis of perceived financial reporting and auditing risks. He said that the PCAOB does not publicly disclose the names of the issuers whose audits are examined, but that it may report issuer names to the SEC depending on the circumstances. He reported that the PCAOB will occasionally ask to interview the audit committee chairperson, not to review the conduct of the audit committee, but, as part of the PCAOB's field work, to seek input from the audit committee chairperson about the auditor or perceived areas of greatest risk in the audit. He identified the following as common inspection deficiency findings relevant for asset managers: (i) failure of the auditor to sufficiently evaluate the appropriateness of valuation methods and the reasonableness of significant assumptions used by the issuer, (ii) failure of the auditor to consider contradictory information, (iii) failure of the auditor to obtain an independent evaluation of pricing because the same pricing service is used by the issuer and the auditor, and (iv) failure by the auditor to either support significant assumptions or test the key data used when auditors elect to develop their own independent fair value measurements. He said that these findings have decreased and the PCAOB is considering whether this is attributable to better audit quality or other reasons.

Investment Company Financial Statement Disclosure Initiatives. Mr. Oswald described the December 2014 Financial Accounting Standards Board ("FASB") proposal that would require registered investment companies to disclose each investment owned by an investee fund if an investment held through the investee fund indirectly represents more than 5% of the reporting company's net assets. He said that the ICI opposed this requirement in circumstances when the investee fund is a registered investment company because the investee fund's holdings are already publicly available. Other concerns he identified were possible portfolio holdings disclosure policy issues and uncertainty as to whether the standard would require a fund to aggregate holdings across investee funds or aggregate instruments issued by the same issuer for purposes of measuring against the 5% threshold. He discussed a FASB proposal to eliminate the fair value hierarchy level for investments in private funds, saying that there is a wide range of reporting practices for private funds that provide periodic liquidity; some issuers characterize private fund investments as level 2 if such investments are redeemable within 90 days, while others use level 2 if interests can be redeemed within 1 year.

Investment Company Consolidation. Mr. Sennett talked about the October 2014 SEC staff guidance on consolidation of investment company financial statements. He discussed different master-feeder and fund-of-funds scenarios, noting that, under the guidance, a feeder fund should normally attach the master fund's financial statements to its own, rather than consolidate, unless it is the sole investor in the master fund, in which case it should consult with the SEC staff regarding the most meaningful presentation of the financial statements. He explained that if the master fund is a partnership, the guidance says that some financial metrics should be disclosed on the feeder fund's statement of operations and some expenses should be included in the feeder fund's expense ratios contained in its financial highlights. He also discussed the SEC staff's position that unconsolidated financial statements are generally most meaningful for a fund-of-funds structure, although significant ownership of an underlying fund can merit a consolidated presentation (similar to what is done for wholly-owned subsidiaries).

Valuation Guidance in Money Market Release. Mr. Sennett noted that, in the wake of the SEC's statements in the 2014 adopting release for amendments to Rule 2a-7 that all funds, including long-term funds, can use amortized cost valuation for securities with remaining maturities of 60 days or less only if they can reasonably conclude each time a valuation determination is made that amortized cost approximates fair value, some funds have abandoned the use of amortized cost for these securities but others have set up processes to compare amortized costs to data from pricing services. He also talked about the new rules for website disclosure of market-based NAVs for floating and stable value money market funds. He discussed the SEC's statements in the money market fund release regarding using market quotations to price thinly traded securities, like money market instruments, and factors that funds and their boards may want to consider when pricing services are used.

PCAOB Projects. Mr. Wixted discussed the PCAOB's proposed changes to auditor reporting standards, which would require the communication of "critical audit matters" ("CAMs") in audit reports and expand the auditor's responsibility for information in shareholder reports outside of the financial statements. He expects that the most likely CAMs for mutual funds would be related to valuation. Mr. Sweet confirmed that, notwithstanding the lengthy deliberation period, the reporting standard is still under evaluation and moving forward at the PCAOB. Mr. Wixted also talked about possible changes in standards for fair value measurements and other matters that were the subject of a staff August 2014 letter and the PCAOB's project on improving audit quality indicators.

Other Topics. Mr. Oswald talked about the elimination of "extraordinary items" from U.S. GAAP, which will likely impact investment company expense cap arrangements that reference (and often exclude) these items. He also talked about possible changes to disclosures related to reverse repurchase agreements and securities lending transactions that could come out of accounting standard update 2014-11.

Session 3-C — Across Borders and Time Zones: Compliance and Risk Management for a Global Fund Business

Moderator: Eva M. Mykolenko, Associate Counsel, International Affairs, ICI Global

Speakers: Maria Gattuso, Principal, Deloitte & Touche LLP
Graham Laybourn, Director of Compliance and Legal, Baillie Gifford Overseas Ltd
Susan R. Ramonat, Director of Enterprise Risk Management, SEI Investments
Beth K. Werths, Senior Vice President and General Counsel, International, Natixis Global Asset Management

This panel provided its views on key challenges facing compliance and risk management for a global fund business.

Key Challenges From a Global Perspective. Ms. Ramonat observed that as a result of events such as the collapse of Lehman Brothers/Northern Rock and large scale tax evasion, directors of regulated entities were being held to higher standards than before. She observed that risk management is now seen as a priority, with many institutions adding employees to handle the increased workload and adopting procedures to demonstrate effective oversight of business operations.

Mr. Laybourn listed five key challenges: (i) the increased complexity facing businesses having to deal with multiple compliance programs, (ii) having to establish a consolidated policy framework covering key aspects such as culture of a firm, its remuneration policy in Europe and its code of ethics, (iii) the increased risk in having to comply with multiple jurisdictions' business conduct rules and the consequential need to have a risk mitigation plan, (iv) having "domestic" knowledge and applying this to foreign jurisdictions/situations, and (v) ensuring legal and compliance frameworks are cohesive and undertaking objective assessments of the adequacy of those frameworks.

Ms. Werths noted that, from a UCITS perspective, the increased use of derivatives for investment purposes has created challenges. For example, many Asian regulators have increased the time taken to get a product to market. The Hong Kong Securities and Futures Commission (the "SFC") has been criticized over the last 2 years over such delays and recently announced its intention to reduce the timeframe for approval to market from 12 months to 6 months. However, in practice, the SFC now wants an informal application before a formal submission (which somewhat circumvents the reduction in time announcement).

Ms. Gattuso noted that growth by acquisition in the asset management industry creates its own regulatory/compliance issues – for instance, the integration of different data models and dealing with conflicting regulatory requirements (particularly in relation to transparency and privacy issues). Ms. Gattuso highlighted compliance with substantial shareholder disclosure requirements as particularly difficult to manage as they are often required under tight deadlines. She further remarked that funds operate regionally (as well as globally) in different time zones and at different pricing points. Ms. Gattuso noted that teams were responding by changing expectations for normal business hours, and Ms. Werths concurred.

Communicating Within Firm Teams. Mr. Laybourn noted that firms now had new financial regulatory development teams in order to create a consolidated view of occurrences across the globe. He then noted three things that his organization had done in response to changing compliance/regulatory obligations: (i) added resources, (ii) put increased focus on compliance/regulatory issues when formulating strategy, and (iii) applied discipline on projects, with project managers increasingly involved in helping to manage the budget and timescales.

Challenges in Dealing with Different Regulations in Different Jurisdictions. Ms. Werths noted that her organization has a small team that is assigned different countries, with lawyers travelling to those jurisdictions on a regular basis. She encourages her team to spend time periodically with law firms, relevant business people and industry groups to gather information on what is going on in the industry and noted that it is challenging for small firms to stay “tuned-in” to industry developments. Mr. Laybourn spoke of the need to focus on law firm relationships and to have someone on the team to keep track of regulatory changes.

Allocation of Resources. Ms. Gattuso noted that when it comes to risk-based resource allocation, there are three pertinent questions to ask (given that resources are finite): (i) does the regulatory change impact you, (ii) how does it impact you, and (iii) what resources are needed.

Mr. Laybourn noted that he looks for a balance of skill sets in his financial regulatory development team; for example some were strong analytically, others had more operational exposure, while there were some with project management experience. Mr. Laybourn’s team comprises six members, who are allocated specific jurisdictions to monitor and who meet with the Head of Legal regularly.

Use of Technology. Ms. Ramonat added that she was looking at systems to monitor compliance risk but noted that she was sceptical about compliance framework systems. Mr. Laybourn also remarked that he warned others not to be necessarily seduced by the idea that a system could answer all issues.

Lessons Learned? Ms. Werths urged the industry not to underestimate the complexity involved when considering new projects. Ms. Ramonat noted that internal collaboration was as important as ever. Mr. Laybourn emphasized the importance of preserving a firm’s culture and protecting its reputation. Ms. Gattuso noted the importance of doing cost-benefit analyses when going into a new jurisdiction and, at times, having a “negative strategy” (*i.e.*, if things do not go to plan/fail, have a plan).

Session 4-A — State Issues Affecting Mutual Funds: Wait, Didn't NSMIA Preempt the States?

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

Speakers: Kevin L. Caravella, Vice President, Blue Sky Administration, Boston Financial Data Services, Inc.
Sarah Mysiewicz Gill, Senior Legislative Representative, AARP
Ryan Lovin, Assistant General Counsel, Investment Company Institute

This panel discussed various state issues and regulations affecting mutual funds, with a particular emphasis on NSMIA.

NSMIA and State Authority Over Mutual Funds. Mr. Caravella provided a brief history of state securities regulations, noting that, prior to the adoption of NSMIA in 1996, funds were required to register at the individual state level using custom filing forms specific to each state. After the adoption and implementation of NSMIA, fund registration took place at the federal level only, with notice filings regarding the intent to sell fund shares still required at the individual state level. In the post-NSMIA world, states essentially lost the authority to regulate the operation of mutual funds and the content of their disclosure documents, but retained the authority to require notice filings and the payment of associated fees, as well as the authority to investigate and bring enforcement actions with respect to, among other things, fraudulent activity.

Mr. Caravella then reviewed the various types of state notice filings and the associated fees, the general requirement to renew state notice filings annually, and the types of transactions that are typically exempt from state fees, including sales to existing shareholders ("SES") and institutional sales. He explained that, given the detailed recordkeeping and other difficulties associated with institutional sales exemptions, funds typically focus more heavily on SES exemptions. For SES exemptions, if certain requirements are met, including that sales are not subject to any commissions, only the initial sales of a fund need to be reported in a given state. Mr. Caravella also reviewed the various sanctions states may impose for incorrect or missing filings, explaining that administrative sanctions, including monetary penalties, are by far the most common course of action taken by the states. Mr. Caravella expressed his opinion that, going forward, states would increase their efforts to obtain sales and other data from funds in an effort to examine the validity of any claimed exemptions and to ensure that all filing fees have been paid in accordance with state law.

State Efforts to Increase Retirement Savings. Ms. Gill reviewed the current state of the U.S. retirement savings market. She explained that approximately half of the "baby boomer" generation and "generation X" are at risk of a financially insecure retirement. A major factor behind this phenomenon is a significant lack of access to retirement savings plans in the workplace. She then discussed state facilitated retirement plans for individuals without access to a retirement plan at their place of work (commonly referred to as “Work and Save” plans). Ms. Gill noted that there has been somewhat of a national movement towards Work and Save plans, with several states having introduced such plans in the past several years.

Mr. Lovin then discussed the Achieving a Better Life Experience Act of 2014 (the “ABLE Act”), explaining that the ABLE Act provided for “529 Plan-like” accounts for individuals that have become disabled before the age of 26. Earnings and distributions for qualified expenses, including educational and medical expenses, are not taxable income, while annual contributions cannot exceed the federal gift tax exemption. Given the recent passage of the ABLE Act, Mr. Lovin explained that there were still many lingering questions about the impact that ABLE Act accounts will have.

State Tax Issues. Mr. Lovin next addressed certain state tax issues at the management company level, explaining that state tax liability generally centered around the management company’s nexus to the state (*e.g.*, is the company’s contact with the state sufficient to give rise to tax liability?) and apportionment (*e.g.*, if the company is subject to tax at the state level, how much does it owe to the applicable state?). With respect to nexus, he stated that some states had developed a somewhat controversial “economic presence” test, which subjects a company that avails itself of a state’s marketplace to taxation, without regard to the lack of any physical contact with the state. This nexus theory was developed to reach, among others, companies that may not have a physical presence in a state but that have significant sales (*e.g.*, online sales) that reach into a given state. Mr. Lovin noted that such economic presence theories are currently the subject of significant litigation, but the U.S. Supreme Court has not yet agreed to hear any cases involving this issue.

State Abandoned Property Laws. Ms. Salmon reviewed various aspects of state abandoned property laws, explaining that all states had some form of law that dealt with the disposition of property that had been deemed abandoned when an owner becomes “lost.” The question of when a property owner had been deemed to be “lost” varies from state to state. Over the years, states have become increasingly aggressive in determining that property has been abandoned, given the substantial revenue that states generate from such property. Ms. Salmon then addressed various methods that both individuals and companies can use to protect themselves, including understanding the triggers for starting the dormancy clock (*e.g.*, returned post office mail or no contact with a financial institution), actively searching for property that will shortly be escheated, and maintaining regular contact (at least once every 3 years) with financial institutions.

Session 4-B — What Every Fund Lawyer Should Know About Derivatives Regulation

Moderator: Jennifer S. Choi, Associate General Counsel, Investment Company Institute

Speakers: Laura A. Coyne, Vice President and Counsel, Wellington Management
Leigh R. Fraser, Partner, Ropes & Gray LLP
Victor Frye, Chief Compliance Officer, ProShares
Jonathan Siegel, Vice President and Senior Legal Counsel, T. Rowe Price Associates, Inc.

This panel discussed the impact of derivatives regulation on registered funds, as well as certain current issues and potential consequences associated with such regulation.

Recent Regulation. The panel began with a discussion of the goals of recent derivatives regulation: (i) greater transparency in the market for derivative instruments, (ii) greater standardization of derivative instrument contracts, (iii) reduction of bilateral credit risk between derivatives counterparties, and (iv) increased trading of such contracts on regulated exchanges and other facilities. Mr. Frye noted that a principal goal of the increased regulatory activity was to prevent the need for governmental intervention in the marketplace of the type that occurred when the U.S. government injected $85 billion into American International Group, Inc.

Cleared Swaps. The panel discussed developments in the regulation of cleared swaps, noting that the regulatory model for cleared swaps has followed in many respects the market for futures contracts. The panelists noted that participants in the market for cleared swaps no longer face their counterparties, but rather face their swap dealers who have access to clearinghouses. The panelists noted that swap dealers now handle issues relating to the posting of the standardized margin required by clearinghouses in respect of cleared swaps. The panelists said that while clearinghouses establish minimums for margin, swap dealers generally reserve the right to require their clients to post additional collateral. The panelists noted that swap dealers have not generally invoked that right yet.

The panelists stated that in respect of cleared swaps, a wide variety of margin remains acceptable. They noted the general preference for cash as margin, but that other forms of margin, such as U.S. Treasury obligations, U.S. Government agency obligations, corporate debt, and equity securities remain acceptable. They also noted that most market participants use cash and U.S. Treasury obligations because very significant haircuts typically apply to lower quality collateral, in effect, requiring significant overcollateralization of trades.

Non-Deliverable Forwards. The panel discussed non-deliverable currency forward contracts. The panel noted that while the CFTC was considering requiring certain non-deliverable currency forward contracts to be cleared, it was not clear whether such a requirement would be delayed given the recent decision by EU regulators to delay such a requirement in Europe. Mr. Siegel noted that the clearing of non-deliverable currency forwards had the potential to affect a much broader group of industry participants than were affected by the clearing of other swaps. He noted that a large number of market participants did not use swaps other than non-deliverable forwards to manage currency exposure.

Un-Cleared Swaps. The panel then turned to a discussion of proposed mandatory minimum margin requirements for un-cleared swaps. Ms. Fraser noted that currently, the margin required for un-cleared swaps remains subject to the bilateral agreement of the parties. She noted, however, that soon mandatory minimum margin requirements would likely be imposed by regulation. She said that trades involving banks will be subject to rules of the prudential regulators, while CFTC-issued rules will generally apply to un-cleared swaps with non-bank parties, except when the swap is a security-based swap with a non-bank counterparty, in which case SEC rules will apply. Ms. Fraser noted that the CFTC-issued rules and those applicable to banks are expected to be generally consistent with the global framework recommended by the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, as well as the requirements proposed by EU regulators. She noted that mandatory bilateral exchange of initial margin and bilateral variation margin will generally be required for most un-cleared swaps. She also noted that the rules generally require variation margin in cash and allow for a minimum transfer amount of $650,000. Ms. Fraser stated that many registered funds do not have to post initial margin under their current negotiated bilateral arrangements, so these changes could impose additional costs on funds.

The panelists then discussed regulations regarding how un-cleared swap collateral is held. Ms. Fraser noted that, historically, registered funds have not typically received initial margin from their dealer counterparties, so new tri-party arrangements would need to be put in place for that initial margin. She also noted that the rules of the prudential regulators, CFTC and SEC allow funds to elect segregation of all of their initial margin (which most funds will feel compelled to elect due to applicable custody requirements under the 1940 Act), but do not limit the amount a dealer can charge a fund for electing to segregate its margin. She explained that proposed SEC rules would impose a capital charge on a security-based swap dealer whose client elected to segregate its initial margin, which the dealers would likely seek to pass on to the fund.

Issues and Consequences. The panelists discussed the many practical problems that result from non-uniform rules applicable to swaps – whether cleared or un-cleared. Mr. Frye stated that intense coordination among a fund’s investment adviser, administrator and custodian was necessary to ensure margin was transferred in the right amounts to the appropriate counterparties, with the consequent importance of observing minimum transfer amounts given that funds may incur transaction-based charges each time margin must be transferred.

Ms. Coyne commented on the difficult custody issues involved with cleared swaps, noting that oftentimes five parties are involved in a single transaction (*e.g.*, the fund, a dealer, the fund's clearing member, the dealer's clearing member and the clearinghouse). She noted that after the trade with the fund clears, the initial dealer counterparty falls away and collateral passes back and forth through the clearing members, relying on the agency model. She said that registered funds can provide margin for cleared swaps to their clearing members under no-action letters issued by the SEC staff, and that such margin is held under the "legally separate, operationally commingled" (LSOC) model. She also noted that such a system involves a number of risks, including fraud, accounting errors and recordkeeping issues. Ms. Coyne contrasted this risk with that associated with un-cleared swaps, where collateral is bi-lateral and, at least in respect of registered investment companies, collateral is kept separately in a tri-party account with the investment company's custodian.

Mr. Siegel noted that the resolution of trading errors has also been made more difficult. He noted that even obvious trade errors noted immediately can no longer be fixed after they have been entered. Instead, he said, new offsetting trades must generally be entered.

The panel then turned to a discussion of the ISDA Resolution Stay Protocol. Mr. Siegel explained that regulations would likely be adopted in the next couple of years prohibiting banks from trading derivatives with entities that had not adhered to this protocol. He noted that by adhering to this protocol, funds would agree to stay their rights to terminate their outstanding derivatives transactions for one or two business days if their counterparty entered certain resolution proceedings, and in certain cases would waive altogether their rights to terminate their outstanding derivatives transactions if their counterparty's guarantor or affiliates of their counterparty entered bankruptcy proceedings. Ms. Fraser explained that, while the purpose of these provisions was to allow for orderly resolution of financial institutions, the provisions many funds had in their trading agreements with Lehman Brothers that allowed such funds to terminate the trading arrangements when the Lehman Brothers parent entity entered bankruptcy were quite helpful. Ms. Fraser noted that these changes, once implemented, could significantly impact the credit analysis to be done with respect to dealer counterparties.

Session 4-C — Funds as Plaintiffs: Considering When and How to Act

Moderator: Matthew Thornton, Counsel, Investment Company Institute

Speakers: John K. Forst, Partner, Deputy General Counsel, Lord, Abbett & Co. LLC
Lowell Haky, Associate General Counsel, Civil and Complex Litigation, Charles Schwab & Co., Inc.
Nora M. Jordan, Partner, Davis Polk & Wardwell LLP
Bruce W. Leppla, Partner, Lieff Cabraser Heimann & Bernstein, LLP

This panel discussed situations in which mutual funds might act as plaintiffs in lawsuits against issuers of securities held in their portfolios, focusing on the duties, cost-benefit analyses, processes and policies relating to funds' involvement in litigation.

Background on Funds' Involvement in Lawsuits. Mr. Leppla outlined a range of circumstances giving rise to funds' claims against companies in which they invest, including disclosure failings, negligence, mismanagement, and indenture/loan compliance. He outlined the range of types of suits in which funds can be involved, including class actions, bankruptcy cases, and actions against underwriters. Following the Private Securities Litigation Reform Act of 1995, large shareholders in companies have typically taken the lead in shareholder lawsuits, he said, though union funds and government retirement plans had generally been more active than mutual funds and private company pension plans. Mr. Haky commented that, in recent years, mutual funds and their advisers had become increasingly involved as plaintiffs in lawsuits, in part because they have become more familiar with the process of litigation and in part because they increasingly consider involvement in lawsuits to be part of their duties as fiduciaries.

Fiduciary Duties of Advisers and Boards. Ms. Jordan explained that there is not clear law on whether an adviser has a fiduciary obligation to pursue lawsuits for its fund clients. She noted several grounds that have been used to claim breaches by investment advisers for failures in pursuing litigation, including Advisers Act and 1940 Act fiduciary duties and compliance rule obligations, and state fiduciary or trust law duties. She drew parallels to the SEC's 2003 rule under the Advisers Act imposing specific obligations with respect to proxy voting of portfolio securities. In 2005 and 2008, the OCIE staff had sent out information requests to registered advisers, asking about the processes used to identify and participate in class action lawsuits. And, Ms. Jordan continued, there was a flurry of lawsuits against advisers following the publication of articles by James Cox and Randall Thomas in 2002 and 2005 asserting that advisers were leaving billions of dollars on the table by not pursuing lawsuits effectively. These lawsuits were either dismissed or settled, so courts never clarified the legal standard.

Procedural and Contractual Best Practices. The panel discussed best practices as to litigation policies, including the sample policies in the conference materials. Mr. Forst stated that the Lord Abbett funds' board receives a memorandum on ongoing litigation matters at every regular meeting, and that reporting by the adviser focuses on a cost-benefit analysis as to whether and how to participate in different suits. The panelists observed a wide diversity in the processes for reviewing and reporting on lawsuits for mutual funds, including the metrics presented as well as whether and when to seek affirmative votes by the fund board. Conflicts of interest at the adviser can arise, as in cases where an affiliate of the adviser is involved in the litigation or where the adviser is acting for a range of different kinds of clients with divergent interests with respect to the litigation, and Ms. Jordan recommended that these conflicts be addressed in funds' and advisers' litigation policies. Ms. Jordan encouraged funds and advisers to address the responsibilities for pursuing litigation explicitly in their investment management agreements, or at least to reach a clear understanding as to the adviser's responsibilities. Mr. Haky described different ways advisers can monitor the progress of cases, including using third-party consultants, law firms and in-house legal resources. While funds may appropriately bear the cost of litigation and related service providers, Ms. Jordan warned advisers to be wary of citing to the size of the adviser's resource commitment as a factor in the cost-benefit analysis of whether to pursue the claim. The panel discussed additional complications that arise when monitoring and pursuing claims against companies in non-U.S. jurisdictions.

Whether to "Opt Out" of Class Actions. The panel discussed the merits and drawbacks of "opting out" of a class action lawsuit. Mr. Forst stated that Lord Abbett follows a cost-benefit analysis in this decision making, and reexamines that analysis as the lawsuit progresses. Mr. Leppla described examples of litigation where his firms' clients that opted out recovered significantly more by opting out, as in the AOL-Time Warner suit, where the investor's opt-out recovery was approximately fifty times the recovery it would have received as part of the class. He noted that opting out can accelerate the receipt of recovery amounts, as class actions entail significant processing delays before investors receive any money. Mr. Forst discussed the recent *IndyMac* decision, which effectively will require advisers to implement additional monitoring processes to avoid a "statute of repose" lapse. Mr. Haky said that Schwab had not chosen to be lead plaintiff and had opted out of class actions seven or eight times in the past five years. Mr. Forst said that Lord Abbett had not been lead plaintiff and had opted out of class actions fewer than a dozen times in the same period.

Industry Trends. The panelists called out trends in litigation by funds: Mr. Haky observed that funds and advisers will continue to be more active and structured in their approach to litigation, Mr. Forst predicted that asset managers would opt out of class actions more frequently as they recognize the potential rewards of doing so, Mr. Leppla predicted seeing more tolling agreements with potential defendants as managers take more time to evaluate their options, and Mr. Forst predicted greater frequency of involvement in lawsuits outside the United States.

General Session — OCIE and Enforcement: A Discussion of Roles and Responsibilities, Priorities, and Coming Attractions

Moderator: Michael J. Downer, Senior Vice President and Secretary, Capital Research and Management Company

Speakers: Andrew J. Bowden, Director, National Examination Program, U.S. Securities and Exchange Commission
Andrew Ceresney, Director, Division of Enforcement, U.S. Securities and Exchange Commission
Randall Lee, Partner, Wilmer Cutler Pickering Hale and Dorr LLP

OCIE Priorities. Mr. Bowden noted that current priorities for OCIE include: (i) payments to financial intermediaries by mutual funds and their sponsor organizations, (ii) "alternative" mutual funds (with a focus on liquidity, leverage and procedures and controls), (iii) fixed income funds (with a focus on the issues identified in IM Guidance

Update 2014-01, including liquidity, stress testing and related board oversight), (iv) never-been-examined investment companies, (v) cybersecurity, and (vi) the ongoing "large firm engagement" initiative. The aim of the large firm engagement initiative is for the SEC staff to "build a relationship" with the world's largest asset management firms, through site visits and interviews with senior management and with the independent directors of mutual funds affiliated with these large asset managers. Mr. Bowden said that the large firm engagement initiative has been underway for 3-4 years and resulted from concerns expressed at the time of the 2008 financial crisis that the SEC staff did not have well-established working relationships with the largest industry participants.

Enforcement Priorities. Mr. Ceresney listed as current asset management priorities of the Division of Enforcement: (i) valuation, performance claims and the presentation of performance, (ii) deviation from investment guidelines or from disclosure relating to investment matters, (iii) investment company governance and the Section 15(c) contract review process, (iv) advisers causing mutual funds to make payments to financial intermediaries that are not in conformity with Rule 12b-1, (v) fees, expenses and related disclosures relating to private equity funds, (vi) undisclosed conflicts of interest, related party transactions and valuation issues (especially where valuation affects fees or performance claims) relating to hedge funds, (vii) conflicts of interest in the management of separate accounts, (viii) failure to adequately address compliance deficiencies identified in prior OCIE examinations, (ix) compliance with the Advisers Act custody rule and (x) undisclosed adviser revenue, such as payments from brokerage firms to investment advisers that may affect the advice that advisers give to their clients.

"Broken Windows" Approach to Enforcement. The panel discussed the SEC's "broken windows" approach to securities law enforcement, which seeks to enhance compliance through the use of enforcement actions in cases of even relatively minor infractions of the law. Mr. Lee noted that this approach has been criticized for diverting scarce resources away from more significant enforcement priorities and for imposing harsh consequences for minor infractions. Mr. Ceresney responded by asserting that the sanctions imposed have been reasonable, and that the focus of "broken windows" enforcement has generally been on industry participants who repeatedly violate particular laws. Mr. Ceresney also said that the program does not consume many resources. The SEC uses computerized data analysis to identify patterns of repeat violations, and institutes substantially similar enforcement proceedings against large numbers of industry participants on a concurrent basis. As examples, he cited the 20 enforcement actions announced simultaneously in September 2014 relating to alleged violations of Rule 105 of Regulation M under the 1934 Act, and the 34 enforcement proceedings announced simultaneously (also in September 2014) against companies and individuals for alleged repeated failures to make timely filings under Sections 16(a) or 13(d) or (g) of the 1934 Act. He said that the SEC has adopted expedited settlement processes that create incentives for the targets of these actions to resolve them promptly and without undue use of agency resources.

Use of Computerized Data Analysis to Guide Enforcement Activity. Mr. Ceresney commented regarding the SEC's enhanced abilities to identify potential enforcement cases through the computerized analysis of large quantities of data. He noted that the SEC now has computerized tools that allow it to identify instances of suspected insider trading on its own, whereas formerly it was largely reliant on referrals from the stock exchanges and other market participants. The SEC is also using computerized data analysis to identify claims of suspiciously strong investment performance, and to detect suspected violations of the broker-dealer customer suitability requirements.

Tips for a Successful OCIE Examination Experience. Mr. Bowden said that registrants can increase the likelihood of having a successful examination experience by taking these steps:

- Provide requested documents and information on a timely basis.
- Designate an individual as the central (but not sole) point of contact for the examiners.
- Allow examiners to talk with the people in the organization who are most knowledgeable about the subject matters into which the examiners are inquiring.
- When providing documents and data, organize them in accordance with the SEC staff's request.

Mr. Bowden noted that OCIE is increasingly asking registrants to provide very large amounts of data. He said that OCIE is generally willing to receive data in the same format in which the registrant itself keeps the data. He noted that, when responding to data requests, it will often be helpful for a registrant to put its information technology professionals in touch with the examiners directly, rather than insisting that the examiners interact only with compliance or other personnel who have insufficient technical knowledge of the registrant's information technologies.

Mr. Bowden said that frequent sources of frustration for OCIE examiners are: (i) unreasonable delays in the production of requested documents or data and (ii) unreasonable assertions of the lawyer-client privilege. Mr. Bowden said that OCIE would like the SEC to bring enforcement actions against registrants who are unreasonably dilatory in the production of documents or data or who assert the lawyer-client privilege without a reasonable basis. In response, Mr. Lee observed that the OCIE staff frequently underestimates the amount of time and effort required to prepare an appropriate response to a document or data request. He also noted the importance of keeping meticulous records of the information that a registrant is providing to examiners (among other reasons, so as to be able to address any later allegation that requested information was not provided, or was not provided on a timely basis), and the importance of a careful pre-production privilege review to ensure that privileged information is not inadvertently provided to examiners.

Mr. Bowden said that OCIE conducts "corrective action examinations." These are examinations conducted to ascertain whether a registrant has in fact remedied deficiencies identified in prior examinations and that deficiencies identified in prior examinations are not recurring.

Enforcement Actions Against Individuals, Including CCOs. Mr. Ceresney said that the Enforcement Division believes that enforcement actions against individuals are "critical" to the Division's efforts and have a larger deterrent effect than actions against entities provide. He noted that approximately 70% of the enforcement actions that the Division initiates involve charges against individuals. He also said that the Enforcement Division is expressly required to provide an explanation to the SEC in every instance in which it recommends enforcement action against an entity but does not propose to charge any individuals.

Mr. Bowden said that, to his knowledge, the SEC is not specifically targeting CCOs or investment company directors for enforcement activity. Mr. Ceresney said that the SEC charges CCOs in enforcement cases when: (i) the CCO affirmatively participated in misconduct, (ii) the CCO misled regulators, or (iii) the CCO "wholly failed" to carry out programs that were within the scope of the CCO's responsibilities.

Payments to Financial Intermediaries. Mr. Bowden said that the SEC staff has not formed the view that payments to financial intermediaries out of mutual fund assets are categorically "too high" or are "hidden." Rather, he said, the focus of OCIE's current interest in payments by mutual funds to intermediaries is on whether fee increases being sought by intermediaries are genuinely for investor servicing, or are in fact a disguised charge for access to the intermediary's distribution channel.

Mr. Bowden acknowledged that it is often difficult to ascertain whether a payment to an intermediary out of fund assets is "primarily intended to result in the sale of [fund] shares." Because these determinations may be difficult and in any case involve the exercise of an important fiduciary responsibility, OCIE expects that the determinations will be the subject of rigorous processes and controls; that all relevant information (including the existence of any conflicts of interest) will be provided to, and carefully reviewed by, the fund board; that the process will be amply documented in the record; and that appropriate disclosures will be made to fund investors.

General Session — Strengthening Our Industry's Reputation Over the Next 75 Years: A Conversation About Ethical Considerations in the Fund Industry

Moderator: Todd Cipperman, Managing Principal, Cipperman Compliance Services

Speakers: Lea Anne Copenhefer, Partner, Morgan, Lewis & Bockius LLP
Andrea Falcione, Managing Director, Performance GRC, PricewaterhouseCoopers LLP
Robert I. Frenkel, Managing Director and General Counsel, U.S. Mutual Funds, Legg Mason
Karen L. Stuckey, Independent Director, OppenheimerFunds

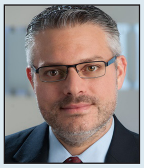
Introduction. Mr. Cipperman reviewed the various sources of ethics laws, rules and regulations in the fund industry, including, among others, those codified in the 1940 Act and the Advisers Act and various state law provisions. He stated that ethical considerations not only involve personal and corporate liability, but also impact the reputation of individuals and firms in the industry.

Role of Counsel. The panel discussed the roles of counsel to funds, advisers (including in-house counsel) and independent trustees and various ethical considerations typically associated with those roles. The panel addressed the ethical questions that face counsel and how certain conflicts or tensions may arise in situations where counsel represents both the fund and the independent trustees or the fund and the investment adviser. Ms. Stuckey highlighted the importance of executive sessions with the independent directors and senior management of the adviser in maintaining open and frank lines of communication.

Role of CCO. The role of the CCO was then addressed by the panel, including potential conflicts associated with an adviser's CCO also serving as fund CCO. The panel discussed the obligation of the fund's CCO to oversee the adviser's compliance program. Ms. Copenhefer said that she did not believe that it was necessary for an independent third party to review an adviser's compliance program, noting that the adviser's compliance staff typically works closely with in-house counsel, as well as fund and independent director counsel, in developing and overseeing the adviser's compliance program.

Whistleblowers. The panel discussed the SEC's Whistleblower Program, noting that this area was relatively new and the full impact of the program was yet to be realized. Ms. Falcione noted that, in her experience, advisers had been taking employee complaints more seriously in light of the Whistleblower Program. The implications of an individual's decision to report a suspected violation of the federal securities laws to the SEC were also discussed, and it was noted that a well-established organizational reporting chain was important in order to ensure that any potential whistleblower claims were adequately addressed.

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



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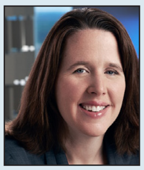

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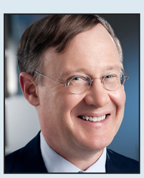

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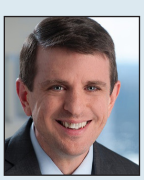

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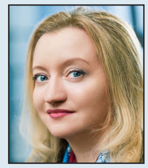

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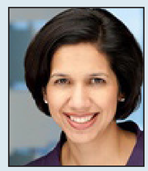

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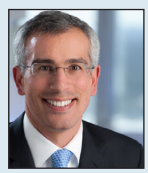

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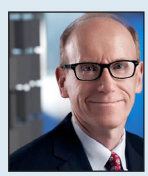

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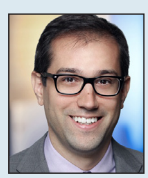

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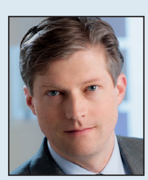

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