2016 ICI CONFERENCE

ICI Mutual Funds and Investment Management Conference Summary

ROPES & GRAY

2016 ICI MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE

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GENERAL COUNSEL'S ADDRESS

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

Mr. Blass opened the conference with a discussion of the SEC's pending proposal to modernize shareholder report communications (the "Reporting Modernization Proposal").

Mr. Blass made a compelling case for permitting mutual funds to utilize, on an opt-out basis, electronic delivery of shareholder reports, noting that it presents opportunities for the industry to innovate. He analogized electronic delivery of shareholder reports to electronic deliveries in other industries, such as banking, healthcare and entertainment, which were significantly improved when they embraced technological innovations. He discussed arguments in favor of electronic delivery based upon benefits to the environment, noting that, with over 240 million shareholder reports being generated annually in the industry, paper shareholder reports have a significant environmental impact. Mr. Blass also noted that a change to electronic delivery would provide important economic benefits to shareholders and could save approximately $2 billion in fund expenses over ten years as a result of a shift to electronic delivery.

Mr. Blass supported the SEC's efforts in facilitating the use of electronic delivery, commenting favorably on the portion of the Reporting Modernization Proposal that preserves the ability of a shareholder to obtain a paper copy of the report on request. He said that the Reporting Modernization Proposal has proved controversial and that the paper industry and the primary vendor hired by brokers to deliver shareholder reports to beneficial owners are actively lobbying against the proposal. Mr. Blass suggested that registered fund shareholders are far more technology savvy than the national average cited by the paper industry in its effort to discredit the country's readiness for electronic delivery. He then explained that the primary vendor delivering shareholder reports to broker clients has argued that the current fee schedule for shareholder report delivery set out in the New York Stock Exchange ("NYSE") rules permits it to charge higher fees for not delivering shareholder reports than it is permitted to charge for delivering shareholder reports. The ICI estimates that the group's position that it could charge four times as much for non-delivery could result in approximately $1 billion in additional costs over ten years. Mr. Blass described the NYSE fee schedule rule as ambiguous as best, and potentially susceptible of an interpretation that would allow brokers to negotiate lower vendor rates and retain the difference.

Mr. Blass urged the SEC to exercise its oversight of the NYSE and suggested regulatory changes to enable the Financial Industry Regulatory Authority ("FINRA") to take over from the NYSE responsibility for the regulation of such fees. The ICI has filed comment letters with the SEC, NYSE and FINRA, calling on the SEC to adopt the modernization proposal and encouraging FINRA to scrutinize broker practices regarding delivery. In conclusion, Mr. Blass requested that the industry think creatively about shareholder report disclosures and how to customize required content for shareholders if the Reporting Modernization Proposal is adopted.

KEYNOTE ADDRESS

Speaker: David W. Grim, Director, Division of Investment Management, U.S. Securities and Exchange Commission

Director Grim began his keynote address by discussing the productivity of the Division of Investment Management ("DIM") over the past few years. He highlighted DIM's accomplishments in 2015, including (i) the release of rulemaking proposals involving the Reporting Modernization Proposal, liquidity, and derivatives; (ii) the issuance of twenty-six no-action letters; (iii) processing of approximately 156 applications for exemptive relief; and (iv) the publication of five IM Guidance Updates.

Pending Rulemakings. Director Grim thanked industry commenters for providing thoughtful responses to rulemaking proposals and encouraged further comment, noting that empirical data and analysis is particularly helpful. The SEC received almost 80 comments on the liquidity risk management proposal. He said that while many commenters recognized the benefits of liquidity risk management programs and swing pricing, some raised concerns about certain aspects of the proposal, including the liquidity classification framework and three-day minimum liquidity requirement. He noted that the comments would inform DIM's thinking as it prepares the final rules. He said that volatility in the bond markets at the end of last year underscores the importance of liquidity risk management. Turning to the Reporting Modernization Proposal, he noted that, although many commenters supported the proposed rule, some raised questions as to whether the receipt of additional information would increase the risk that the SEC would be a target for cybercriminals. He stated that the SEC remains focused on cybersecurity and plans to bolster its ability to respond to cybersecurity intrusions. Director Grim noted that the comment period for the derivatives proposal closes at the end of March and stated that DIM looks forward to reviewing industry comments.

Recent Events. Director Grim noted that DIM staff is analyzing Third Avenue Management's decision to wind down its Focused Credit Fund last December and expressed his view that any fund contemplating suspending redemptions should inform DIM as soon as possible. He noted that some investment strategies, such as those focusing heavily on distressed debt, may be more suitable for closed-end or private funds, rather than open-end funds, and stated that funds should ensure that their strategies are appropriate in light of their structure. He commented that the Third Avenue fund events also demonstrated the importance of the liquidity risk management proposal.

Risk Disclosure. Director Grim discussed the most recent IM Guidance Update that relates to risk disclosures in changing market conditions. He noted that the guidance (i) highlights the need for funds to monitor market conditions and assess whether disclosures continue to accurately describe risks; (ii) encourages funds to consider all appropriate means of communicating with investors regarding updated risk disclosures; and (iii) provides examples of how some funds have revised certain risk disclosures in connection with changing market conditions.

Other Initiatives. Director Grim reported that DIM is working on proposed rules that would require advisers to create and implement transition plans for major disruptions in business. In addition, he stated that DIM is developing new stress-testing requirements for large advisers and investment companies. He described how a recent market event – a computer malfunction that prevented a financial institution from calculating funds' per share net asset values ("NAVs") correctly – underscored the importance of mitigating operational risk through business continuity policies. In his view, when funds outsource critical functions to third parties, they should conduct diligence on such service providers' business continuity and disaster recovery plans, determine how to best monitor whether a disruption has occurred that would affect the service providers' ability to provide uninterrupted services, and consider steps to mitigate any such disruptions.

GENERAL SESSION

The Regulatory Outlook for Funds and Advisers

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

Speakers: Diane C. Blizzard, Associate Director, Rulemaking, Division of Investment
Management, U.S. Securities and Exchange Commission

John M. Loder, Partner, Ropes & Gray LLP

Laura J. Merianos, Principal, The Vanguard Group, Inc.

Paul F. Roye, Director, Capital Research and Management Company

This panel discussed recent and pending regulatory matters, in particular the IM Guidance Update regarding mutual fund distribution and sub-accounting fees (the "Distribution in Guise Guidance"), and regulatory trends for mutual funds and advisers.

Regulatory Environment. The panel opened with a discussion of the current regulatory landscape and commented on the considerable amount of rule-making and guidance issued by the staff of the SEC over the past year. Mr. Loder cited several significant regulatory developments that may have industry-changing effects, including the implementation of money market reforms; the Distribution in Guise Guidance; and the proposed rules regarding liquidity and derivatives. In reference to the proposed rule regarding derivatives, Mr. Roye discussed the concern expressed by the SEC through its rulemaking that certain alternative strategies may not be appropriate in an open-end retail fund structure. Mr. Loder also noted that the Department of Labor (the "DOL") fiduciary rule may change the distribution landscape and lead to modifications of mutual fund share class structures. The panel discussed the specialized competency required at fund companies to meet the requirements of the proposed liquidity and derivatives rules.

The panel discussed the encroachment of the DOL and federal banking regulators into matters that had historically been regulated primarily by the SEC. The panel discussed an apparent shift in recent SEC rulemaking from a principles-based approach to a more prescriptive approach. The panel questioned whether a prescriptive approach, which is more akin to the approach traditionally taken by banking regulators, was the most efficient and effective means to regulate capital markets. Ms. Blizzard commented that addressing operational risk does not fit neatly within the existing regulatory framework and stressed the need for there to be a high level of communication among the regulators on these issues in an increasingly complex environment.

Distribution in Guise Guidance. The panel discussed the Distribution in Guise Guidance, which was issued following a multi-year sweep examination conducted by the SEC's Office of Compliance Inspections and Examinations ("OCIE"). Mr. Loder provided an overview of the key points from the guidance, noting that it focused on payments made outside of a plan adopted pursuant to rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act"). He stated that the guidance reaffirmed that a fund board has a significant role in oversight of these services and payments and that he considered the guidance to be measured, moderate and constructive.

Mr. Blass asked whether the staff expects fund boards to make factual inquiries and determinations or whether their role is to monitor for conflicts of interest and seek assurances from management. Ms. Blizzard responded that boards should take a holistic approach and have an understanding of payments for distribution and non-distribution services and the relationship between a fund and its intermediaries. She added that if a board has a robust process, it is likely not to be challenged and that a board may rely upon information provided by the fund's adviser and Chief Compliance Officer in its review. She noted that boards should focus upon those intermediaries with atypical relationships and larger intermediary relationships and that the staff does not necessarily expect boards to look at the details of each and every intermediary relationship. Mr. Loder noted that the guidance did not specify a frequency required for the review of these relationships but that in his experience an annual review was typical.

The panel discussed the difficulties that a fund complex may encounter in obtaining information from third-party intermediaries. Mr. Roye commented on the SEC's recent Advance Notice of Proposed Rulemaking relating to transfer agency regulation, noting that these intermediaries are performing functions that would otherwise be performed by the fund complex's transfer agent. He questioned whether the transfer agency regulation should apply to these intermediaries as well.

Additional DIM Guidance. Ms. Blizzard stated that the staff of DIM was working on additional guidance based upon the generally positive feedback it has received from the industry. The panel expressed concern regarding the use of guidance as a rulemaking tool, and Mr. Loder noted that examiners sometimes fail to distinguish between law (established in statutes and regulations) and guidance, which is not law. Ms. Blizzard stated that the aim of such guidance is to provide the industry with a better understanding of staff views. Ms. Merianos commented that it would be helpful if staff guidance would provide best practice examples in addition to discussion of areas of potential non-compliance.

Risk-Based Agenda for Regulatory Initiatives. Ms. Blizzard said that DIM was using a risk-based agenda in setting rulemaking priorities. The panel discussed various initiatives, such as the rulemakings on liquidity and derivatives, and expressed concerns regarding the increasing burden that is being imposed on independent directors, notably the requirements to make certain determinations that are considered by many industry participants to be more appropriately made by management. Ms. Blizzard said that the roles of the SEC and the Federal Stability Oversight Council ("FSOC") are complementary, and that the SEC will pursue its own regulatory priorities at its own pace.

GENERAL SESSION

The Future of the Fund Industry

Moderator: Michael J. Downer, Senior Vice President, Capital Research and Management Company
Speakers: David Abner, Head of Capital Markets, WisdomTree Investments, Inc.
Karen Dunn Kelley, CEO of Fixed Income and Senior Managing Director of Investments, Invesco Worldwide Fixed Income
Stephen J. Kaplan, Head of Product Strategy Americas, JP Morgan Funds
Joseph Lai, Associate Partner, McKinsey & Company

The panel discussed the future of the U.S. fund industry, focusing on the potential effects of new and expanding regulation, active versus passive investment strategies, the development of solutions-based products, and anticipated trends in distribution and related technologies.

Effects of New and Expanding Regulation. Mr. Downer suggested that the plethora of new and expanding regulation in recent years and related costs and complexities will tend to drive smaller investment management firms out of the U.S. fund industry and serve as a barrier to entry going forward. As an example, he cited the ongoing consolidation of the money market fund industry in response to the major reforms adopted by the SEC in 2014. He cited the DOL's proposed fiduciary rule as an example of regulation that may profoundly impact how 1940 Act funds are designed and distributed and effectively "pick winners and losers" in the marketplace. Mr. Kaplan expressed the view that regulation designed to reduce certain risks may create other risks, noting that the DOL's proposed fiduciary rule will limit investment advice available to retail investors and that the SEC's proposed liquidity risk management rule may lead to constrained portfolios with lower long-term returns available to investors.

Active versus Passive Investment Strategies. Ms. Dunn Kelley noted that passive U.S. equity strategies have significantly outperformed analogous active strategies during the long bull market following the 2008-2009 market crisis, and have captured significant additional market share among 1940 Act funds. She noted, however, that the relative success of active and passive management tends to be cyclical and should be assessed over full market cycles. Ms. Dunn Kelley also noted the emergence of "strategic beta" funds, which occupy a middle ground between active and passive funds by tracking innovative indexes that are constructed differently than traditional, market-cap-weighted benchmarks.

Development of Solutions-Based Products. Mr. Lai discussed the significant growth of funds, such as managed volatility and target date funds, which are designed to meet particular objectives and provide solutions for investors, rather than focusing on benchmark-driven returns. He said that such products have grown in favor among retail investors, particularly since the 2008-2009 market crises, due to market volatility and additional pressures on fiduciaries to recommend products that satisfy a particular need in an individual's portfolio. Mr. Downer noted that the dramatic decline in the use of defined benefit plans has led to a situation where many workers in the U.S. do not have access to effectively guaranteed returns and are very fearful of the effects of swings in the market on their retirement savings invested through defined contribution plans. Mr. Lai expressed the view that typical target date funds do not fully address this situation because the investor base is generally underfunded. Mr. Abner suggested that more sophisticated asset allocation models, such as those that take into account longevity risk and whether an individual is underfunded at a particular point in time, can help to address this problem.

Distribution Trends. Mr. Abner noted anticipated evolutions in fund distribution in the coming years, including a continuing trend toward lower-cost, index-based products, a movement from commission-based to fee-based/asset allocation products, a rise in the use of "robo" advisers and automated asset allocation models, increased reliance on "big data" analytics to develop enhanced investment products and indexes as well as distribution strategies, and a trend toward greater portfolio transparency.

The panelists generally agreed that the DOL's proposed fiduciary rule, if adopted, will lead to an increase in fee-based products that invest principally in passively managed, low-cost funds and the use of robo advisers and other automated investment solutions.

SESSION 1-A

RIC Tax Update

Moderator: Karen Lau Gibian, Associate General Counsel, Tax Law, Investment Company Institute

Speakers: Scott Meissner, Senior Director, Mutual Fund Taxation, TIAA

Jessica Reif-Caplan, Senior Legal Counsel, Fidelity Investments

William P. Zimmerman, Partner, Morgan, Lewis & Bockius LLP

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

European Union Tax Reclaims. Mr. Meissner opened the panel by discussing the status of European Union ("EU") tax reclaims, noting that the focus of EU court cases has shifted to whether non-EU funds are comparable to EU funds. One particular issue for the EU courts has been whether sufficient information to conduct a comparability analysis can be obtained. In this regard, the SEC has started providing certifications on comparability, and Poland has reached out to the Internal Revenue Service (the "IRS") for information. Mr. Meissner then turned to accounting considerations relevant to U.S. funds that have EU reclaims, including when a fund should recognize a pending EU tax refund, which may differ depending on the country.

Ms. Gibian discussed the U.S. tax consequences for those funds that receive refunds, focusing on IRS Notice 2016-10 (the "Notice"), issued in January 2016. The Notice adopts, with modifications, the ICI's proposed method of netting refunds against foreign tax credits in the year the refund is received (the "netting method"). While the guidance provided by the Notice is much appreciated by the industry, Ms. Gibian noted several remaining issues. For example, the Notice does not permit the netting method where the amount of a refund exceeds foreign tax credits for that year, such that funds with even a de minimis amount of excess refunds would be required to seek a closing agreement. The ICI has requested that the IRS and Treasury permit carryovers of such excess for a reasonable period (e.g., five years). The ICI has also requested that funds predominantly owned by insurance companies be permitted to use the netting method, which is not currently permitted by the Notice.

Money Market Fund Reform Tax Issues. Ms. Reif-Caplan discussed several open issues being faced by money market funds. The ICI has requested a number of clarifications in respect of proposed regulations that permit shareholders in money market funds with a floating NAV to compute gain and loss on shares in such funds on an inventory-type method (the "NAV method"). Ms. Reif-Caplan also described several open tax issues for stable NAV funds that charge a liquidity fee, suggesting that future guidance should allow shareholders in such funds to use the NAV method. In addition, guidance has been requested to (i) clarify that such a fund may treat liquidity fees as paid-in capital, without the recognition of gain or income or the reduction in the tax basis of its assets, and (ii) provide that a distribution of liquidity fees will not be treated as a return of capital to shareholders.

The panelists then discussed diversification issues being faced by government money market funds that support variable insurance contracts ("VA funds"). VA funds must meet a diversification test under Section 817(h) of the Internal Revenue Code that limits the percentage of their assets that may be invested in any one, two, three or four issuers. Because there are only five main issuers of U.S. government securities, funds are concerned that there will be insufficient supply of each issuer to allow the funds to comply with the diversification test. The ICI has requested relief from the IRS, which if granted would deem government money market funds that comply with Rule 2a-7 to meet the Section 817(h) diversification test if certain conditions are met.

The panelists briefly discussed transition-related matters, such as adviser contributions and dividing a fund with institutional and retail shareholders into separate funds on a tax-free basis. The IRS has asked that the industry prioritize the requests for guidance with respect to money market fund reform, and the ICI has suggested that the matters discussed in the paragraphs above take priority.

Implications of the SEC Derivatives Proposal on Commodity Funds. Mr. Zimmerman discussed the potential impact of the recent SEC derivatives proposal on funds that have obtained an IRS private letter ruling or opinion of counsel regarding the favorable tax treatment of offshore subsidiaries that engage in commodities investing. In connection with such rulings and opinions, most funds made a representation to the effect that the offshore subsidiary will comply with the Investment Company Act Release No. 10666 and related SEC guidance pertaining to asset coverage. If the proposals in the SEC derivative release supersede Release No. 10666, fund groups believe that it would be extremely difficult for offshore subsidiaries to comply with the new rules on a standalone basis. Mr. Zimmerman speculated about the consequences if the proposed rule becomes final, including whether funds could continue to rely on private letter rulings, whether funds should go back to the IRS to request removal of the representation at issue, and whether tax counsel would continue to require the representation at issue.

Section 871(m) Regulations: Withholding on Dividend Equivalents. Ms. Reif-Caplan described that open-end funds are treated as "brokers" for purposes of regulations issued under Section 871(m) of the Internal Revenue Code. Under the regulations, brokers are required to complete calculations, such as delta calculations, with respect to equity derivatives and to meet specific recordkeeping and reporting requirements. Funds are unlikely to have the systems in place to comply with these requirements, and the ICI has asked that an exception for open-end funds be included in the regulations.

Common Reporting Standard. Ms. Gibian noted that the U.S. fund industry should begin to pay attention to the Common Reporting Standard ("CRS"), which was developed by the OECD and is described as "FATCA for everyone else." The CRS has been adopted by 55 countries, and 40 more countries are expected to adopt the CRS by 2017. Although the U.S. is not a participating country, U.S. funds may need to provide information under the CRS to financial institutions with which they have an account.

SESSION 1-B

Navigating the Current Mutual Fund Litigation Landscape

Moderator: Julia S. Ulstrup, Vice President and General Counsel, ICI Mutual Insurance Company, RRG
Speakers: Paul B. Goucher, Vice President and Chief Counsel, Ameriprise Financial, Inc.
David Kotler, Partner, Dechert LLP
Stephen G. Topetzes, Partner, K&L Gates LLP

This panel focused on three key areas of fund litigation activity: (i) excessive fee claims under Section 36(b) of the 1940 Act; (ii) state common law claims; and (iii) prospectus liability claims under the federal securities laws.

Excessive fee claims. Ms. Ulstrup explained that after the U.S. Supreme Court's landmark 2010 decision in Jones v. Harris Associates, many in the industry had hoped that shareholders and plaintiffs' lawyers would be dissuaded from bringing new claims. Not so. Since Jones, 24 cases have been asserted against the advisers of 21 different fund groups – six in the last year alone. Nineteen of these cases are still active. Mr. Topetzes provided an overview of the legal framework governing claims under Section 36(b), which is the only private right of action provided to fund shareholders under the 1940 Act. The statute provides a claim against the adviser and other service providers for alleged breach of fiduciary duty with respect to the receipt of compensation. The Supreme Court held in Jones that the Second Circuit had previously stated the correct standard of liability in its well-known Gartenberg decision: that a fee must be so disproportionately large that it bears no reasonable relationship to the services and could not have been the product of arm's-length bargaining. While pre-Jones cases focused heavily on comparisons of fund fees to fees charged by the same adviser to institutional separate accounts, the more recent post-Jones cases have focused more on comparison of fund advisory fees to sub-advisory fees. Some of these cases focus on the amounts paid to the adviser defendant in excess of the amounts it paid to the sub-adviser of the funds in question, while others focus on the amounts that the adviser defendant charges as sub-adviser to non-proprietary funds.

Mr. Topetzes reported that the last year has seen no landmark developments in excessive fee litigation. A number of motions to dismiss were denied, which is not especially surprising in light of the presumption in favor of the plaintiffs' factual allegations at this procedural stage. There was a notable affirmance by the Ninth Circuit of the granting of a motion to dismiss in an older case, including a helpful discussion of standing. But for the most part, cases are percolating along. One case is in the midst of being tried in the District of New Jersey, and other cases are in the midst of or nearing summary judgment briefing – so the coming year may see more notable developments.

Mr. Kotler noted that, in response to an oft-asked question as to when this wave of new cases will end, evidence suggests we are not yet at the end of the wave. Cases are being brought against advisers of all shapes and sizes, including by new entrants from different parts of the plaintiff's bar. It appears that no adviser can consider itself "safe" from Section 36(b) claims based on the nature of the firm or the fact that it hasn't yet been sued. Mr. Topetzes added that the industry and defense bar are still awaiting a court to tackle the "inapt comparison" issue vis-à-vis sub-advisory fees head-on. Mr. Goucher suggested from the in-house counsel perspective that the ongoing wave of excessive fee claims should cause fund firms to focus carefully on the rigor of their 15(c) processes – and in particular, the treatment of sub-advisory fee comparisons. The panelists also noted the importance of annual disclosure of the 15(c) process, as this can be an area of focus of the plaintiffs in discovery.

State Common Law claims. Mr. Kotler explained that a controversial 2015 decision by the Ninth Circuit Court of Appeals in Northstar v. Schwab had caused concerns of a new wave of state law claims being brought against funds, advisers and trustees. The Northstar decision involved three essentially unprecedented holdings: (i) that a fund prospectus could be seen as a contract between the fund and the shareholders, on which the shareholders could sue directly for breach; (ii) that shareholders have standing to sue advisers and trustees directly for alleged breach of fiduciary duty, rather than bringing such claims derivatively on behalf of the fund (which carries procedural safeguards); and (iii) that shareholders can sue the adviser directly for breach of the advisory agreement, as supposed "third-party beneficiaries" of such agreements. The Supreme Court declined to take up the case on certiorari. Fortunately, the wave of claims based on these theories that many in the industry feared has not come to pass, and there have been positive developments potentially narrowing the available scope of such claims. In Northstar itself, on remand to the district court, the judge ultimately dismissed the plaintiff's claims on another basis – that the gravamen of the claims was alleged prospectus misrepresentations, leaving the claims precluded under the SLUSA statute. A similar case was filed against another adviser, claiming (like Northstar) that the fund was not managed in accordance with the prospectus disclosures. That case was also dismissed as precluded by SLUSA. Both cases are on appeal to the Ninth Circuit on the SLUSA issue. While neither of these recent district court decisions upends the troubling reasoning of the Ninth Circuit regarding the availability of state law causes of action, the availability of a SLUSA defense may at least narrow the range of theories under which plaintiffs can pursue such claims. Mr. Topetzes stated the view that instances of arguably failed investments or violations of investment restrictions may well lead to Northstar-type claims (with emphasis on breach of fiduciary duty), and he anticipates we will see continued attempts by plaintiffs.

Mr. Goucher discussed steps that some fund boards and advisers are considering to blunt the effect of the Ninth Circuit's reasoning in Northstar and essentially maintain the status quo regarding litigation claims. These steps include the addition of forum selection clauses into fund documents to ensure cases are brought in a forum expert in the underlying state law; express discussion in the fund disclosures regarding intended third-party beneficiaries of service agreements; and clarifying the respective definitions of direct and derivative litigation claims as applicable to a given fund complex.

Prospectus Liability Claims. Mr. Kotler reported that after a period of relative quiet for a few years, the filing of securities class action claims regarding mutual fund prospectuses and related disclosures has picked up in the last year. The recent uptick appears to be driven by specific events and particular firms, rather than suggesting a new wave of plaintiff activity in this area. For example, one defendant firm had a serious liquidity issue requiring liquidation of a high-yield fund, while another experienced a surprise performance reporting issue from an external sub-adviser. Mr. Topetzes added that the recent cases often reflect the plaintiff's bar bringing opportunistic claims, jumping on the coattails of an SEC enforcement action against a fund or adviser. Mr. Goucher counseled that the recent liquidity issues at the fund complex now facing litigation underscore the value of focusing carefully on liquidity – because of both the litigation risk and the forthcoming SEC rule-making on liquidity. Now is an opportune time to be proactive in analyzing and monitoring portfolio liquidity risk, as well as what fund disclosures might say about liquidity risk. The risk of liquid assets becoming illiquid is of course ever-present, but the negative consequences can perhaps be lessened with strong disclosures regarding such risk. This includes looking across an entire business to ensure that disclosures are consistent across business lines.

SESSION 1-C

Making Sense of Equity Market Structure: Complexities and Conflicts

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

Speakers: Kevin Cronin, Global Head of Trading, Invesco

Daniel M. Gray, Acting Head of the Office of Analytics and Research, Division of Trading and Markets, U.S. Securities and Exchange Commission

Annette L. Nazareth, Partner, Davis Polk & Wardwell LLP

Ira P. Shapiro, Managing Director, BlackRock

The Panel discussed recent efforts by the staff of the SEC to gather intelligence and insights regarding recent market volatility and issues raised by the current structure of the U.S. equity markets.

August 24, 2015. The Panel began with an explanation of the events of August 24, 2015. On that day, bad news out of China and the New York Stock Exchange's invocation of Rule 48 resulted in numerous delayed openings of individual equities. These delays and lack of price and demand indicators led to significant price dislocations for many names, but especially for US equity ETFs. It was noted that the actual pricing and information issues lasted only about 30 minutes, but price volatility experienced by many ETFs led to a series of "limit-up/limit-down" ("LULD") trade halts that delayed a return to fair value by hours in some cases.

Mr. Gray shared four observations about August 24th: (1) there was a surge of price sensitive selling right after the market open; (2) there was a sharp drop in liquidity (especially for exchange traded products ("ETPs")) as market makers and others stepped away from the market for a time due to lack of accurate pricing indications; (3) despite these challenges, many securities and ETPs did not experience price dislocations; and (4) for certain securities, especially U.S. equity ETPs, the LULD halts were problematic as they delayed market participants from discovering the fair value.

The Panel next discussed the rationale for LULD halts, noting that they were put in place after the 2010 "Flash Crash," as well as the inconsistent price bands enacted by the major exchanges. The Panel also explored the imprecise "clearly erroneous" trade rules, noting that market participants had no way of knowing whether trades that were executed at significant discounts to opening prices would subsequently be labeled "clearly erroneous." Discussion then ensued regarding order types, with the Panel noting that certain order types, principally "stop-loss" orders that turn into market orders once a certain price is reached, contributed to volatility and price declines.

ETP Trading on August 24. To provide context for the challenges that faced many ETPs that day, Mr. Shapiro explained typical ETP trading mechanics. He noted that newer and more retail-oriented funds do not necessarily have deep two-way trading markets, and that many ETPs rely more heavily on market-makers than traditional equities. He added that while ETP market-makers are obligated to make periodic two-way markets, they are not buyers of last resort and will stop quoting if they perceive that they are taking on too much risk. Mr. Shapiro explained that traders and market-makers did not have accurate information regarding the value of many of the underlying U.S. equities, so the ETP arbitrage mechanism, which normally kicks in to keep ETP prices in line with the value of their underlying securities, was not functioning properly.

ETP Industry Recommendations. The Panel next discussed a letter sent to the Commission on March 10 by a number of ETP-industry participants, including the largest ETP families and numerous market-makers, that purports to represent the "consensus" view regarding ETP trading issues. The letter noted that (i) the price collars imposed by the exchanges at the open and close did not function well and should be realigned, (ii) the LULD mechanism hampered many ETPs' ability to get back to fair value, and (iii) the exchanges' reopening mechanisms are insufficient. The group also recommended that, after a trading halt, all liquidity should be routed to the halted ETP's primary listing venue so that traders could get a strong sense of the unfragmented liquidity that is available upon reopening. The group also recommended that the "clearly erroneous" rules be harmonized and that the exchanges be required to declare when a trade price was clearly erroneous. Mr. Gray indicated that the Commission staff appreciated all of the thoughtful feedback it had received and that it is considering the feedback while it conducts its own research into equity market trading issues.

Other Trading Challenges. The Panel then touched on the July 8 trading issue experienced by the NYSE. On that day, due to a technical issue, the NYSE experienced a three-hour trading halt. Fortunately, the issue was resolved in time for the regular closing auction to occur, and there was no lasting impact on the market as a result of the glitch. Mr. Cronin noted that a significant percentage of all trades are "market on close" trades that feed into fund NAVs, and added that having fragmented liquidity is not necessarily compatible with getting to a single closing price for a security.

Mr. Gray then explained that the Commission staff is working with the exchanges on improving the flow of trading information to market participants. It was noted, however, that what was missing is often quality information from buy side participants regarding order routing practices and other issues.

Finally, there was a brief discussion of the current "maker/taker" fee model, where liquidity takers are charged fees to access liquidity and liquidity makers are given rebates to provide liquidity. Ms. Choi noted that the ICI is inclined to argue against maintaining the maker/taker model.

SESSION 1-D

It Takes a Village: Fund Relationships with Service Providers and Intermediaries

Moderator: Rachel H. Graham, Associate General Counsel, Securities Regulation, Investment Company Institute

Speakers: Keith A. Bovardi, Partner, PricewaterhouseCoopers LLP

Basil Fox, President, Franklin Templeton Investor Services LLC

Michael F. Hogan, Chief Compliance Officer, Charles Schwab Investment Management, Inc.

Frank J. Nasta, Managing Director, Head of JPMorgan Funds Management Legal, J.P. Morgan Asset Management

This panel addressed issues associated with service provider oversight and risk management.

Service Provider Arrangements. The panelists began by commenting on the increase in the number and complexity of outsourcing arrangements between advisers and service providers. Mr. Bovardi noted that, while these arrangements allow advisers to focus on their core competencies, advisers should be cognizant of the risks associated with outsourcing (e.g., strategic, operational, compliance, reputational, business continuity and information security risks). He emphasized that advisers can outsource certain functions, but they cannot outsource their responsibilities with respect to the risks associated with those functions.

Testing. The panelists discussed steps that an organization can take in testing service providers. Mr. Bovardi noted that advisers should review the data each third party provides, compile scorecards or other systems of evaluation, and assess what additional steps should be taken depending on the party's risk profile. Mr. Nasta noted that the oversight of service providers is not a task performed in isolation; it is part of the day-to-day relationship with the service providers.

Diligence and Onboarding. Mr. Hogan noted that, as service provider relationships increase in complexity, advisers should integrate more experts into the diligence process. Mr. Nasta described his organization's robust diligence process prior to onboarding a service provider, which includes a review of responses to requests for proposals by an internal service provider team, onsite visits, review of service provider policies, and ranking of service providers in categories from most risky (e.g., custodians) to least (e.g., financial printers).

Regulatory Developments. The panelists noted two regulatory developments on the horizon that could affect service provider relationships. First, they addressed the SEC's Advance Notice of Proposed Rulemaking relating to transfer agent regulation, which included notice proposals relating to transfer agency registration and reporting requirements, safeguarding of funds and securities, and cybersecurity and information technology. Next, they discussed the FSOC focus over the past year on the operational risks that may arise when multiple advisers rely on a limited number of third parties to provide key services, including valuation and portfolio risk management.

Managing Intermediary Relationships. The panelists next discussed oversight of financial intermediaries. Mr. Fox noted that the Financial Intermediary Controls and Compliance Assessment ("FICCA") framework, which was developed in connection with a shift in intermediaries' business models toward aggregate omnibus accounts, has helped create a standardized way for financial intermediaries to report on the effectiveness of their controls. He noted that advisers' and financial intermediaries' interests generally are aligned with respect to compliance matters.

Areas Requiring Heightened Attention. In considering areas that may require heightened attention from a service provider management perspective, the panelists discussed valuation, sub-transfer agency services and cybersecurity. Mr. Hogan discussed the need for clear processes around the selection and oversight of valuation service providers. He noted that he has observed more frequent onsite diligence visits to valuation service providers, more detailed methodology around oversight and an increase in service providers reporting directly to fund boards. Mr. Fox discussed the SEC's focus on distribution and sub-transfer agency fees and services and noted the importance of distinguishing between distribution and service functions in intermediary agreements. In addressing cybersecurity, Mr. Hogan noted two recent OCIE risk alerts on cybersecurity and the NFA's Information Systems Security Programs interpretive notice, which will require member firms to adopt written policies and procedures to secure customer data.

Navigating a Business Interruption. Mr. Bovardi discussed the importance of business continuity and contingency planning. He recommended that advisers conduct live tests that force personnel to work through issues while operating in full contingency mode. Mr. Hogan noted the pitfall of focusing on readiness for specific events after they happen, as the likelihood of recurrence is low. He noted improvements in business continuity in connection with the general increase in the number of people who are working remotely.

SESSION 2-A

Across the Board: A Discussion of Hot Topics Affecting Fund Boards

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

Speakers: Darrell N. Braman, Vice President and Managing Counsel, T. Rowe Price Associates, Inc.

Woodrow W. Campbell, Of Counsel, Debevoise & Plimpton LLP

Margery K. Neale, Partner, Willkie Farr & Gallagher LLP

This panel focused on the evolution of fund board responsibilities, including the appropriate role of fund boards, changes in regulatory requirements over time and the implications of these new responsibilities.

Appropriate Role of Boards. Mr. Campbell stressed that the role of a fund board is oversight, not management. He noted that in many instances – including asset valuation, good investment performance and compliance – the interests of fund boards and advisers are well aligned.

Mr. Braman said the SEC's compliance program rule (Rule 38a-1 under the 1940 Act) was "balanced" in the obligations that it imposes on directors, noting that it reflects that the board acts in an oversight role. Mr. Campbell discussed the trend in which the SEC has added violations of Rule 38a-1 to the list of substantive violations in enforcement settlements. Ms. Lancellotta observed that in some contexts the SEC improperly has taken the view that the role of fund boards is to act as the SEC's "eyes and ears," a role that she considers inconsistent with the board's proper role as a fiduciary.

Changes in Legal Requirements over Time. Ms. Neale noted that for many years, fund directors had very few specific duties imposed by or under the 1940 Act (e.g., approval of advisory contracts). She observed that directors' responsibilities have expanded significantly in recent years. As an example of expansion, she cited the obligations imposed on directors under the rules relating to fund governance, compliance policies and procedures and money market funds. Ms. Neale noted that significant additional responsibilities would be imposed on boards under proposed SEC rules relating to liquidity management and derivatives.

Board Responsibilities under Proposed Rules. Mr. Braman commented regarding new board responsibilities under the proposed liquidity management and derivatives rules, which he said would force boards into the role of acting as risk managers. He said that the proposed liquidity rules are similar to Rule 38a-1 in some respects (e.g., both require initial board approval and periodic reporting), but also require boards to make determinations that require investment judgment (e.g., approving each fund's three-day liquid asset minimum). Similarly, the proposed derivatives rules would require boards to approve one of two alternative portfolio limitations for each fund, a task requiring familiarity with "value at risk" or VaR testing and other technical risk management concepts.

Board Responsibilities under Distribution in Guise Guidance. Mr. Braman noted that boards should have a well-designed process for ensuring that funds are not making payments for distribution outside of Rule 12b-1 plans, and should focus on understanding distribution as a whole to inform their business judgment regarding the character of payments. Ms. Neale stressed the importance of board education regarding the role of intermediaries, ongoing board reporting, and monitoring payment data to identify any trends meriting additional scrutiny (e.g., an increase in fund sub-recordkeeping payments relative to the adviser's revenue-sharing payments).

Implications of New Board Responsibilities. Ms. Neale discussed the possible use of board committees to discharge these new responsibilities. She noted that some boards aren't comfortable delegating significant responsibilities to committees, and discussed the need for additional infrastructure (i.e., legal and compliance personnel in each committee room) if two or more committees meet contemporaneously to discuss complex matters. Mr. Campbell said that boards may need more directors to handle these additional responsibilities, and may opt to look for specific backgrounds or expertise (e.g., compliance, information technology, derivatives, liquidity).

Other Boardroom Topics. In response to a question from the audience, Messrs. Braman and Campbell said that in some cases, independent directors accompany management on due diligence trips to key vendors, such as pricing vendors. In response to a question relating to board oversight of cybersecurity, Mr. Braman said that if management provides proper education for directors and provides the board with access to the appropriate experts, boards should be able to properly discharge their responsibilities without adding cybersecurity experts to the board.

SESSION 2-B

Do You Know What's Lurking in Your Data? The SEC Can Tell You

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

Speakers: Robert Dearman, Vice President, Strategic Initiatives, Jackson National Life Insurance

Kathleen Ives, Senior Vice President and Director of Internal Audit, OppenheimerFunds

Satish Lalchand, Principal, Forensic and Investigations, Deloitte Transactions and Business Analytics LLP

Christof W. Stahel, Assistant Director, Division of Economic and Risk Analysis, U.S. Securities and Exchange Commission

Christopher Stavrakos, Senior Financial Analyst, Risk and Examinations Office, Division of Investment Management, U.S. Securities and Exchange Commission

The panel focused on three key points: (1) the SEC is collecting much more data from investment management firms than ever before; (2) the SEC's ability to analyze/utilize this data has been enhanced dramatically; and (3) in view of the SEC's enhanced data collection and analytical capabilities, investment management firms need to have a higher level of understanding and utilizing their data.

Data collection and analysis. The panelists from the SEC's Division of Economic and Risk Analysis (DERA) and DIM's Risk and Examinations Office (REO) summarized the SEC's enhanced data collection capabilities. Mr. Stahel noted that DERA has grown significantly during the past several years and now employs more than 70 Ph.D. economists. DERA is collecting more data from registrants, market data, as well as commercially available data, in an effort to examine practices, activities and specific events involving a broad range of market participants, including public companies, private companies, investment management firms, broker-dealers and other registrants. He noted that the changes to Forms N-CEN and N-PORT included in the proposed rules will assist DERA and the SEC to better understand data relating to mutual funds and ETFs. He stated that DERA has the ability to convert commercially available data (e.g., Morningstar and Bloomberg data) into "structured" data that can help the SEC identify benchmarks, outlying events, trends and specific events.

Mr. Stavrakos outlined REO's evolution within DIM, in accordance with section 965 of the Dodd-Frank Act, noting that REO employs more than 20 persons, including attorneys, portfolio managers, examiners and analysts. REO has numerous goals: to inform policy within DIM by understanding market and other dynamics; to recommend examination priorities; and to perform both ad hoc and organized outreach to the regulated community. REO reports include regular internal reports (such as a bi-weekly fixed income market review), as well as specific event analysis (such as reports relating to the August 24, 2015 trading halt on the NYSE). REO analyzes information from a variety of sources, including Form PF, Form ADV, MIDAS and Edgar. While some of its reports are external (such as quarterly Form PF aggregate data reports that are posted on the SEC's website), most REO reports are for solely internal distribution and consumption within the SEC.

Investment management firms need to have a greater understanding of and appreciation for the SEC's enhanced data collection and analytical capabilities. According to Mr. Lalchand, the investment management industry's understanding of the SEC's data capabilities is a 4 on a scale of 1-10. Many firms are in the 2-3 range and a much smaller number are at higher levels. Mr. Lalchand recommends that investment management firms need to be more proactive rather than reactive. Firms need to "go deeper" into their own data and must apply resources to continuously upgrade and update their data systems. He emphasized that the SEC has personnel with excellent qualifications who have the ability to analyze large and complex data sets. While data collection is important, he emphasized that "people are much more important than software." He also noted that it is more difficult to come up to speed the longer firms wait to become more engaged in data-enhancement activities.

What firms should be doing. Mr. Dearman laid out several steps that firms should take to improve their data collection and analysis. First, he stated that firms need to aggregate data (noting that various "silos" within some firms utilize different data sets that make it difficult or impossible to compare data firm-wide). Second, he stated that firms must work to ensure that aggregate data are "clean" and "reliable." Third, firms need to work to link such data with internal units and processes. Finally, firms should work to link such data to external sources.

Ms. Ives strongly recommended that firms communicate with their internal audit teams, noting that firms do not appreciate the fact that internal audit often has data and analytical tools that the rest of the firm may not be utilizing. Firms often have duplicative data in different parts of the business and it can be very helpful and productive to consolidate data firm-wide and to ensure that such data is reliable and stay ahead of the SEC and other regulators in terms of identifying areas of concern. While IT departments may be responsible for the "data container," they may not necessarily be the right people who take responsibility for "data hygiene." Mr. Dearman emphasized that someone within the firm needs to "own" the data.

SESSION 2-C

Running for Cover: Derivatives Investments Under the 1940 Act

Moderator: Kenneth C. Fang, Assistant General Counsel, Securities Regulation, Investment Company Institute

Speakers: Amy R. Doberman, Partner, Wilmer Cutler Pickering Hale and Dorr LLP

Karen L. Skidmore, Senior Associate General Counsel, Franklin Templeton Investments

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

John M. Zerr, Managing Director and General Counsel, U.S. Retail, Invesco

This panel discussed proposed Rule 18f-4 under the 1940 Act regarding the use of derivatives by registered funds.

SEC Perspective. Ms. Doberman noted that the legislative history of the 1940 Act shows that Section 18 was designed to limit the capital structures of funds, and asked Mr. Townley how this provision could be used to limit the notional amount of derivatives entered into by funds. Mr. Townley explained that it was the SEC's aim to set a clear framework for the use of derivatives by registered funds, replacing Release 10666 and over 30 no-action letters. He also said that the SEC believed that the existing derivatives guidance issued by the staff of the SEC no longer met the purposes of Section 18 of the 1940 Act, because funds that segregated only their mark-to-market exposure under derivatives could incur significant leverage. However, he said that the SEC recognized that requiring funds to segregate the full notional amount of derivatives would not be practical. He also explained that the 150% portfolio limitation in proposed Rule 18f-4 seemed consistent with the framework of Section 18, which allows a fund to borrow money and obtain exposure up to 150% of its net asset value.

Impact on Existing Funds. Mr. Fang discussed an ICI survey that indicated that the DERA study used as a basis for the proposed rule understated the impact of the proposed rule on taxable bond funds. He also noted that certain funds that had recently gone through the process of registering with the SEC and a lengthy exemptive order process might no longer be allowed to operate as registered investment companies if the rule were adopted as proposed. Mr. Townley responded that he did not consider the SEC registration process to be a statement of policy as to the use of derivatives. He also indicated that he expects that certain leveraged ETFs might need to seek additional exemptive relief under the rule.

Portfolio Limitations. Mr. Zerr explained some concerns with the provision in the rule that would limit a fund's notional exposure to derivatives, financial commitment obligations and other senior securities transactions. He stated that it was a common industry view that notional exposure is not a valid measure of risk, since different derivatives with the same notional amount can give rise to significantly different risks. Mr. Townley noted that Section 18 does not distinguish between different uses of leverage, which could also give rise to different risks. He also explained that hedging transactions count toward the proposed portfolio limitations, because it is too difficult to define hedging and that, instead of excluding hedging transactions, the SEC's intent was to set the portfolio limitation thresholds high enough to take hedging transactions into account.

Mr. Zerr said that it would, as a practical matter, be impossible to measure the value-at-risk of a fund immediately after entering into each senior securities transaction, as would be required under the proposed rule. Mr. Townley invited comments to the proposed rule on these types of operational considerations, noting that industry participants were in the best position to raise such issues to the attention of the SEC staff.

Qualifying Coverage Assets. Ms. Skidmore expressed some concerns with the requirement in the proposed rule that funds must segregate qualifying coverage assets to cover a fund's obligations with respect to derivatives transactions and financial commitment obligations. She said that limiting qualifying coverage assets for many derivatives transactions to cash and cash equivalents could create a cash drag on the performance of funds. She suggested that financial commitment obligations should not be counted toward the portfolio limitation tests, since funds were required to segregate the full notional amount of such transactions, thereby eliminating the possibility of leverage in these transactions. The panel discussed the aspects of the proposed rule that would require a fund's board to make certain determinations that they felt would be more appropriately made by the investment adviser, including the choice of portfolio limitation to be used by the fund.

Ms. Doberman observed that the limitation of qualifying coverage assets to cash and cash equivalents could disrupt a fund's normal portfolio management process, especially for ETFs and funds that track an index, and therefore do not hold a significant amount of cash. She said that, alternatively, the SEC's concern with the possible decline in value of other types of qualifying coverage assets could be addressed by applying "haircuts" to the value of such assets. This approach would be similar to that used by the U.S. prudential regulators and CFTC in their recently adopted rules regarding margin requirements for uncleared swaps. Mr. Townley said that the CFTC margin rules were adopted shortly after Rule 18f-4 was proposed, and that the SEC staff was considering such an approach.

Derivatives Risk Management Program. The panelists discussed the requirement that certain funds adopt a derivatives risk management program, including the role of the derivatives risk manager. Mr. Townley said that funds with a straightforward derivatives strategy, such as a covered call strategy, may be able have the CCO serve as derivatives risk manager. However, he expected that derivatives risk management would be a separate function that would not be performed by the CCO for funds with a more complicated use of derivatives. Ms. Doberman noted that it could be helpful to include portfolio managers on a derivatives risk management committee given their expertise with the risks of derivatives.

SESSION 2-D

Rules of Engagement: Funds' Interaction with Their Portfolio Companies

Moderator: Matthew Thornton, Assistant General Counsel, Securities Regulation, Investment Company Institute

Speakers: Donna F. Anderson, Global Corporate Governance Analyst, T. Rowe Price Associates, Inc.

Peggy Foran, Chief Governance Officer, Corporate Secretary, Prudential Financial

Holly J. Gregory, Partner, Sidley Austin LLP

Zachary M. Oleksiuk, Director, Head of Americas Investment Stewardship, BlackRock, Inc.

This panel discussed asset management considerations regarding communications with portfolio companies.

Mr. Thornton opened the panel by noting that there is more to portfolio company engagement than just "activist investing" and that many in the fund industry believe that engagement with portfolio companies can be productive. Ms. Gregory expressed her view that portfolio company engagement is a commitment to engage in a dialogue with portfolio companies and that portfolio companies and their boards are increasingly incentivized to understand shareholder concerns and communicate their strategies. She said this communication should be reciprocal; portfolio companies should provide information, but should also listen to the concerns of their shareholders. It was stressed that this communication should not only take place when there is an issue or a potentially controversial shareholder vote, but should be comprehensive and ongoing. She added that portfolio companies are most effective when they put in place a program to learn about shareholder concerns and design their communications around those concerns.

Industry Practices. Ms. Anderson said T. Rowe Price may decide to engage with a portfolio company for a variety of reasons, including transactional, executive compensation or strategy questions. She said and added that a fund's investment strategy will also influence whether to engage with a portfolio company. Ms. Anderson said her firm considers whether: (i) it is a long-term investor of sufficient size to have an impact; (ii) the feedback is constructive, or just whining; and (iii) engaging with the portfolio company make a difference.

Mr. Oleksiuk discussed the evolution of BlackRock's view on portfolio company engagement. He said the firm has gradually moved away from reliance on proxy advisers, and has its own team to evaluate proposals. In his view, the decision whether BlackRock should engage is based upon fiduciary responsibilities and how they may relate to value creation. He then discussed several considerations such as (i) how the portfolio company board works with management to create value; (ii) the financial and other incentives at the portfolio company; (iii) audit and accounting issues; (iv) a portfolio company's governance structure; (v) environmental, social and governance ("ESG") issues; and (vi) how "success" will be defined and measured. BlackRock generally takes an inquisitive approach and suggested that a prescriptive approach can be unproductive given that boards are likely hearing concerns from a range of investors and investor types.

Mr. Oleksiuk commented that whether an account is passive or active influences a decision on whether to engage – active funds can choose to sell a security whereas passive funds generally cannot. He pointed to a growing recognition across the money management industry that passive managers also have duties to consider engagement when it might add value, especially because they are constrained in their ability to sell. His view is that the quality of the engagement is more important than quantity. Also, merely voting against management isn't always helpful and a vote is a very blunt instrument, while engagement is more nuanced. Engagement is also moving beyond the proxy season and is becoming a continuous process, and fund director engagement has increased over time.

Benefits of Engagement. Ms. Foran described several benefits of engagement from the perspective of the portfolio company, noting that it helps to develop relationships that can be beneficial in the future. She said that in her view the largest benefit to portfolio companies from speaking to their shareholders is that it prevents surprises and, further, that portfolio companies can also learn about "best practices" and hot button issues. There are different categories of shareholders with which portfolio companies need to engage: (i) large, but often not activist, shareholders, (ii) influential shareholders, who may not have large positions but are often taking activist positions and are tenacious, and (ii) retail investors. She recommended that, when dealing with retail investors, portfolio companies need to take additional steps, such as having clear and understandable documents aimed at retail investors. She said that, many times, meetings with investors are helpful and productive.

Legal Issues to Consider. Ms. Gregory discussed several legal issues that should be considered regarding portfolio company engagement, including: Regulation FD; insider trading; proxy solicitation rules; anti-fraud; and antitrust regulation. Ms. Anderson noted that in some markets it is possible for asset managers to collaborate with each other on engagement with companies. She said the legal issues of the particular market need to be considered, as does the need to protect the manager's independence and information. Ms. Gregory said she does not always advise asset managers to involve fund directors in the engagement process, although they can be valuable in the right circumstance. It depends on the context and the issue. She said it is important to ensure that fund directors don't engage on their own, but instead the engagement must be coordinated with management so that the company has a consistent message.

Who Engages with the Portfolio Company. The panel discussed the persons best positioned to engage with portfolio companies, noting that the issue being discussed may drive who participates in a discussion and such person should be chosen with care and should be someone who will listen, will not be defensive and can productively converse with the activist. For example, the asset manager's CEO may not be the right person to discuss portfolio company CEO compensation.

KEYNOTE ADDRESS

Speakers: Timothy G. Massad, Chairman, Commodities Futures Trading Commission ("CFTC")

Mr. Blass and Mr. Massad discussed recent accomplishments and areas of focus for the CFTC.

Mr. Massad began with a review of the CFTC's recent accomplishments, including recent agreements with European regulators on centralized clearing houses and the CFTC's adoption of a rule governing margin arrangements for uncleared swap transactions. Mr. Massad commented that he believed a robust market for uncleared swaps would remain and that such market would continue to serve as an important source of innovation.

Mr. Massad said that the CFTC remained aware of the industry's desire for harmonization across regulatory regimes. In this regard, however, he noted that industry participants do not have any areas of their businesses that have truly harmonized regulations across geographies. He noted that this was likely to remain the case given that each regulatory body and government has its own priorities and constituencies. He said it might be unrealistic to believe that markets for swaps would evolve differently simply because the market for swaps was global before swaps were closely regulated in many jurisdictions.

Mr. Massad discussed the events of the August 24, 2015, when the values of certain ETFs declined rapidly and in excess of their underlying markets, and the interplay of securities markets and futures markets. He stated that the CFTC would continue to evaluate efforts to harmonize the futures and securities markets with respect to issues of stabilization, limits up and down, and market openings and closings.

Mr. Massad stated that he and European Commissioner for Financial Stability, Financial Services and Capital Markets Union, Jonathan Hill, have announced targets for equivalence for the regulation of central clearing counterparties, with a June 21, 2016 target adoption date. He said that the measures, if adopted, would grant equivalence with respect to certain margin requirements, reducing the opportunity for regulatory arbitrage by market participants. He noted that the equivalence standards remained subject to a number of procedural measures and approvals.

In response to questions regarding the CFTC's focus on cybersecurity, Mr. Massad stated that the CFTC had determined to propose a principles-driven regime with requirements for controls and vulnerability testing, including independent testing. He noted that a principles-driven regime was well-suited to issues of cyber security given that any prescriptive protocol requirements would quickly become obsolete.

GENERAL SESSION

The Known Unknowns: An Update from OCIE and Enforcement

Moderator: Heidi W. Hardin, General Counsel, Harris Associates L.P.

Speakers: Andrew Ceresney, Director, Division of Enforcement, U.S. Securities and Exchange Commission

Ghillaine Reid Melbourne, Partner, Schoeman Updike & Kaufman LLP

Marc Wyatt, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission

This panel provided an opportunity to hear from OCIE and the Division of Enforcement regarding recent activities and initiatives.

Cybersecurity. Ms. Hardin opened the panel by discussing the SEC's focus in recent years on cybersecurity matters. She cited (1) OCIE's 2014 targeted cybersecurity examinations of 50 broker-dealers and investment advisers, (2) OCIE's September 15, 2015 National Exam Program Risk Alert setting forth areas of examination focus relating to cybersecurity, (3) DIM's April 2015 cybersecurity guidance (IM Guidance Update No. 2015-02) and (4) the inclusion again in 2016 of cybersecurity on OCIE's published list of examination priorities.

The panel discussed the SEC's September 2015 enforcement settlement against R.T. Jones Capital Equities Management, Inc., in which a registered investment adviser was sanctioned for failure to adopt written policies and procedures reasonably designed to protect customer records and information, in violation of Rule 30(a) of Regulation S-P. Mr. Ceresney said that R.T. Jones "will not be the last case in this area; we have others in the pipeline." Mr. Wyatt said that OCIE expects that registrants will have performed reasonable "due diligence" and ongoing testing regarding their outsourced information technology and data security vendors. He noted that outsourcing will not insulate a registrant against regulatory exposure for inadequate data security.

Mr. Wyatt said that OCIE is transparent, risk-based and data-driven. As evidence of OCIE's commitment to transparency, he noted OCIE's practice of publishing its areas of examination focus in advance, and of issuing statements of key findings afterwards. OCIE uses risk-based analysis to determine its examination focus.

"Big Data." Mr. Ceresney said that the last five years have been transformative for the SEC's examination and enforcement efforts, as a result of the agency's greatly enhanced access to data and data analysis tools. He cited a number of categories of enforcement activity in which analysis of large amounts of data had been useful, including (1) reviewing large quantities of market trading data to identify suspicious trading patterns that might suggest insider trading, (2) review of FINRA TRACE data to identify suspicious activity by market participants, including possible "parking" or improper dealer markups on securities, and (3) comparative analysis of company financial statements, to detect outliers that warrant special scrutiny. Mr. Wyatt said that OCIE uses "big data" analysis both to identify which registrants to examine and to assess information provided by registrants during examinations. He said that it is "a myth that OCIE looks at only 10% of registrants." In fact, he said, OCIE looks at the entire set of registrants, in order to identify firms that appear to be outliers and warrant closer scrutiny. He noted that OCIE has data analysis programs that have been developed with the assistance of former high frequency traders, code programmers and game designers. He said that factors that might lead OCIE to focus on a particular firm include (1) an investment performance record that is suspiciously strong or consistent and (2) a high senior executive or CCO turnover rate.

Whistleblowers. Ms. Hardin noted that in fiscal 2015 the SEC received nearly 4,000 whistleblower tips and paid out over $37 million in whistleblower awards. Mr. Wyatt said that OCIE recently completed a sweep examination of registrants' employment, confidentiality and separation agreements to assess whether they contain provisions that violate SEC Rule 21F-17, which provides (with limited exceptions) that no person make take any action to impede an individual from communicating directly with the SEC staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement. The panel discussed the SEC's April 2015 enforcement settlement with KBR, Inc., relating to KBR's practice of informing employees who are interviewed as part of a company internal investigation that they are prohibited from discussing the matter without the authorization of the company's law department and may be terminated if they do so. Ms. Reid Melbourne noted that internal investigations need to be conducted very carefully in light of the KBR settlement. She suggested that company warnings to employees regarding the confidentiality of internal investigations should include a carve-out for whistleblower communications to the SEC.

Cooperating with SEC Investigations; Self-Reporting. The panel noted the September 2015 memorandum issued by Deputy Attorney General Sally Yates setting forth policies of the U.S. Department of Justice relating to "cooperation credit" in Justice Department investigations of corporate wrongdoing, and the prosecution of individuals in cases involving alleged corporate wrongdoing. Mr. Ceresney noted that the Yates memorandum "has no impact on the SEC," and that the SEC has for years observed many of the principles laid out in the memorandum. He also said that registrants can maximize the cooperation credit they may receive from the SEC by self-reporting violations that come to management's attention. He noted the SEC's February 2015 settlement with Goodyear Tire & Rubber in a Foreign Corrupt Practices Act case in which Goodyear completely avoided monetary penalties because it had displayed an exemplary level of cooperation with the SEC's investigation. Ms. Reid Melbourne differed with Mr. Ceresney, saying that self-reporting can be "really, really risky," especially if the company self-reports before it has developed a clear, comprehensive remediation plan relating to the matter being reported. She noted that there is no guarantee that the SEC will give meaningful cooperation credit if a company does self-report. In response, Mr. Ceresney said that a company should not delay self-reporting until a matter has been fully remediated. He said that the Enforcement staff looks favorably on self-reporting that is accompanied by a plan for further investigation and/or remediation.

How the SEC Staff Identifies Matters for Examination and Enforcement. Mr. Wyatt said that the OCIE staff spends a great deal of preparation time before making an examination site visit to a registrant. OCIE tries to limit the scope of its examinations to areas of key risk. He noted that approximately 10% of examinations result in "no findings" letters, 10% result in referrals to Enforcement and 80% result in the issuance of deficiency letters. These percentages have remained relatively constant over the past five years.

Procedural Matters Relating to Enforcement Activity. Mr. Ceresney discussed that the SEC staff is sensitive to the need for special care in instituting enforcement proceedings against compliance officers and said that proposed Wells notices against lawyers and compliance officers typically receive heightened internal staff scrutiny before issuance.

The panel discussed the SEC's practice of instituting some enforcement proceedings as internal administrative proceedings (to be decided by SEC administrative law judges) rather than as lawsuits in federal district court. Mr. Ceresney said that 70-80% of litigated SEC enforcement proceedings are still being brought in federal district court. He argued that internal administrative proceedings have the advantage of typically proceeding more expeditiously, with the result that witness testimony is taken while recollections are still relatively fresh. He also expressed the view that SEC administrative law judges are sophisticated fact finders. Ms. Reid Melbourne said that the SEC has a distinct "home court advantage" in internal administrative proceedings, including strict discovery limits, and questioned whether SEC administrative law judges are necessarily more sophisticated adjudicators of these cases than federal district judges would be.

SESSION 3-A

Cybersecurity: An Exercise in Asymmetric Warfare

Moderator: Peter G. Salmon, Senior Director, Operations and Technology, Investment Company Institute
Speakers: Alex Cunningham, Information Security Officer, State Street Global Advisors
Matthew McNamara, Senior Security Manager, Eaton Vance Management
Richard H. Walzer, Director of Security Services, Putnam Investments

This panel focused on the continuing importance of cybersecurity within the fund industry.

ICI Initiatives Regarding Cybersecurity. Mr. Salmon opened the panel by describing the support that the ICI has made available to its members with respect to cybersecurity, such as the Chief Information Security Officer Advisory Committee, which meets several times a year to share information and insights, and the ICI one day cybersecurity forum. He noted that the ICI began a cyber blog last month and expects to continue to post on topics of interest and importance relevant to cybersecurity issues. The ICI also has a website resource center which includes, among other things, a list of questions that a firm may wish to consider when evaluating its own cybersecurity program, as well as questions that a firm may wish to ask of it service providers.

Cyber Attacks on Firms. Mr. Cunningham discussed the risk of cyber attacks and the impact of social media and noted that a key risk to businesses is the information that employees post about themselves on social media. For example, an employee might post information about his/her birthday and this information, when coupled with readily accessible business and educational data available on sites such as LinkedIn, makes it easier for hackers to then obtain the employee's complete date of birth. Mr. Cunningham said that 91% of all cyber attacks begin with phishing attempts and cautioned firms to educate employees about phishing.

Cyber Incident Response Plans. Mr. McNamara then discussed the need for firms to develop and test a cyber incident response plan. He stated that an incident response plan should assess the scope of the impact and should include protocols to shut down ancillary systems, as needed. He stated that the plan should identify key stakeholders and all those who need to be notified in the event of a breach. He further stated that the plan should have a menu of options to respond to each hypothetical breach scenario. It was discussed that many firms are conducting "war games" or "table-top" exercises wherein key stakeholders take part in a mock hacking drill. Mr. McNamara explained that firms would be well served to have external communication plans in place as part of their cyber response plans (i.e., draft press releases and notifications to regulators) as such communications will be time-sensitive in the event of a cyber incident. He noted that many firms have retained information technology (i.e., forensic) firms and/or law firms specializing in cyber-related matters to assist in cybersecurity issues. He stressed that having these relationships established in advance will save significant time in a crisis scenario. Mr. McNamara emphasized the synergies between these drills and a firm's business interruption/disaster recovery programs and underscored the need to test programs frequently. He suggested that metrics on testing of an investment advisory firm's program should be reported to the board of the funds that the firm manages.

Mr. Walzer then discussed reporting of cyber incidents. He stated that, as recently as a couple of years ago, firms were inclined to not report breaches, but most states now have reporting obligations separate from those required by federal law. Mr. Walzer then discussed steps firms can take to reduce the risk of a cyber attack. He stated that two factor authentication systems have become an industry best practice. Mr. Walzer then commented that internal audit plays a critical role in the development of sound cybersecurity programs given its access to senior management and fund boards. However, most internal auditors are accustomed to testing for control environments whereas an effective cybersecurity program requires a risk-based approach.

Cybersecurity and Service Providers. Mr. Walzer then discussed best practices with regard to fund service providers. He stated that the first step firms should take is to have their vendors complete a questionnaire regarding their cybersecurity programs. He stated that the questionnaire should ascertain whether the service provider has, in turn, sub-contracted services to another firm (if so, firms will want to know who that vendor is and what its protocols are). He advised that firms will then want to monitor their vendors (he noted that there are services that track breaches). Disclosures that a vendor makes about its cybersecurity program in regulatory filings (i.e., its 10-K) can also be reviewed and compared to the responses the vendor provided in the questionnaire. He added that on-site diligence visits are a good practice.

SESSION 3-B

Accounting and Auditing Update

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

Speakers: Jaime Eichen, Partner, Ernst & Young LLP

Matt Giordano, Chief Accountant, Division of Investment Management, U.S. Securities and Exchange Commission

Steve Sadoski, Vice President and Assistant Treasurer, Natixis Global Asset Management

Ms. Eichen opened the discussion by providing an overview of recent Public Company Accounting Oversight Board ("PCAOB") activities, including the promulgation of Accounting Standard ("AS") 18 which she expects to be a focus of PCAOB inspections. Mr. Giordano added that the staff of the SEC believes AS 18 applies to interfund lending and rule 17a-7 transactions under the 1940 Act. He said the staff expects to see both qualitative and quantitative disclosure in financial statements regarding interfund lending and rule 17a-7 transactions, including information about aggregate purchases and sales. He noted that materiality should be determined by aggregating transactions, not on a CUSIP-by-CUSIP basis.

Ms. Eichen then briefly discussed a PCAOB project to reorganize the PCAOB auditing standards in a logical order that generally follows the flow of the audit process. She noted that the new numbering is effective as of December 31, 2016, but that auditors may begin using the new numbers earlier. She also noted that in 2014 the SEC was publicly critical of the relatively slow pace at which the PCAOB had been adopting new auditing standards, and that the SEC had just approved a new budget for the PCAOB with a 12% increase in a 2-1 vote.

Mr. Giordano then explained a structural change within DIM. Previously, the disclosure group contained both legal and accounting reviewers who reported to a branch chief. He said those accountants now report to him instead of the branch chief. He hopes that the new structure will create greater consistency in staff comments and increase its ability to address no-action letter requests, exemptive orders and policy matters.

Mr. Giordano then highlighted a few aspects of the recent concept release on audit committee disclosures. He said that the staff is considering whether the proposal should apply to open-end funds and whether to revise the definition of audit committee financial expert.

Mr. Giordano then discussed certain issues relating to the SEC's Reporting Modernization Proposal. He described changes to derivatives disclosures that would list on a separate schedule each type of derivative instrument, pulling them out of the notes to the financial statements. He said that there has been broad support for that change, but that the proposed changes to tax disclosures have been characterized by some as too granular. Some commenters have remarked that the schedule of investments is not the appropriate place to identify illiquid holdings in light of proposed form N-PORT. Some commenters had expressed concerns about related costs and auditability of changes to the financial statements, and resistance to the proposal for public disclosure of revenue splits for securities lending.

Swing Pricing. Mr. Giordano and Ms. Eichen discussed the implications of swing pricing for financial statements and total return calculations. Highlighting the complexities that result from swing pricing, Ms. Eichen noted that within her firm there was no single consensus on whether total return should be calculated based on transactional NAV, book NAV or an NAV determined without regard to swing pricing (since the "increase" in book NAV resulting from the swing factor is an amount that is intended to cover transaction costs). She said that the SEC has proposed using the transactional NAV, but that her firm believes that the SEC should do further outreach to get industry perspectives.

FASB Disclosure Framework Project (Proposed ASU) for Fair Value Measurements. Mr. Sadoski described the FASB Disclosure Framework Project (Proposed ASU) for Fair Value Measurements (Topic 820). He observed that the following disclosure requirements, among others, would be removed: amount of and reason for transfers between Level 1 and Level 2 and the valuation processes for Level 3 measurements. He said that the new disclosure requirements included additional information about Level 3 fair value measurements and information about changes in unrealized gains and losses, disaggregated by fair value level. He explained that, compared to Topic 820, commenters had been more critical of a sister proposal regarding disclosures in the notes to the financial statements (Topic 235). He explained that this proposal seeks to improve the effectiveness of financial statement note disclosure, but that many had been critical of the proposed materiality threshold. Ms. Eichen expressed concern with having an auditing standard defined with respect to a legal standard, as proposed, and stated that the language could result in inconsistent application.

Additional Matters. Mr. Giordano explained that, in the wake of the NYSE trading halt on July 18, 2015, the staff expects registrants to revisit their disclosure and policies and procedures about NAV calculation to ensure that they clearly state what would happen in unusual circumstances, such as if trading had not resumed in an event like that on July 18. Mr. Giordano then described developments in the peer-to-peer lending space and noted that a number of funds that plan to invest in peer-to-peer loans are in the process of registering. He noted that none have been declared effective and that they face some accounting challenges, for example, the question of whether each individual loan or participation needs to be separately valued when a block of loans with similar characteristics (such as FICO score or geography) are purchased.

SESSION 3-C

Untangling the EU Regulatory Process – How Does it Work?

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

Speakers: Patrick Bergé-Vincent, Managing Director, Europe, ICI Global

Gregory P. Dulski, Senior Corporate Counsel, Federated Investors, Inc.

Ida L. Levine, Director and Senior Legal Counsel, Capital International, Ltd.

This panel provided an in-depth description of the European Union (EU) regulatory process, with an emphasis on how it compares to the U.S. regulatory process.

The panel opened with a general overview of the framework of the EU and a description of the European regulatory process and its key players. It was noted that the European Commission is not itself a regulator and that the relevant regulators include ESMA, EBA, ESRB at the EU level and such agencies as FCA, AMF, BAFIA at the member state level. Relevant trade associations are: EFAMA (a collection of associations and corporate members), ICI Global and local member state associations.

The panel next discussed the EU regulatory process, noting the absence of a public comment period once a rule is proposed. Instead, proposals are subject to parliament and council debate. Currently, the industry has no real ability to challenge the rulemaking process. However, copies of proposed legislation are sometimes leaked in advance for review and consideration. The hierarchy of the EU regulatory framework is:

Level 1: Directive or Regulation

Level 2: Delegated act supplements or amendments to non-essential elements of Level 1 directives or regulations

Level 3: Guidance (the panel noted that EU guidance considered to be more binding than its equivalent in the U.S.)

Level 4: Enforcement

The Panel then discussed portfolio manager remuneration and money market fund regulation as examples of how the EU regulatory process works. The panelists discussed the merits of and difficulty posed by the regulatory framework, noting that the process was not transparent.

The panel also provided an update regarding MI-FID II, noting that it is akin to the Securities Exchange Act of 1934 Act, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 rolled into one. Ms. Levine focused on the rule banning commission sharing arrangements and soft dollars, noting the industry surprise at the subsequent prohibition because the rule did not include any ban on soft dollars under Level 1 of the regulatory hierarchy. The panel observed that a leaked version of the rule came out in December 2015, which indicates that progress seems to have been made on this point and that the rule may be further delayed a year. The panel also discussed the impact on several regulatory processes of the uncertainty as to whether the UK will stay in the EU.

The panel closed with a discussion of the general context and cultural background for EU regulatory processes. Mr. Bergé-Vincent advised that, when U.S. managers interface with EU regulators, they should be cognizant that regulators in the EU have diverse backgrounds in terms of prior expertise and substantive knowledge. Mr. Dulski advised that U.S. managers need to understand the background and relevant strategic alliances and be aware of considerations in addition to the particular issue they are seeking focus upon when engaging in an EU regulatory process.

SESSION 3-D

The DOL: Fiduciary Rule: What You Need to Know

Moderator: David M. Abbey, Deputy General Counsel, Retirement Policy, Investment Company Institute
Speakers: Bradford P. Campbell, Counsel, Drinker Biddle & Reath LLP
Robert J. Doyle, Vice President, Government Affairs, Prudential Financial
Stephanie L. Napier, Senior Counsel, The Vanguard Group, Inc.

This panel discussed the controversial pending rulemaking initiated by the DOL in 2015 relating to conflicts of interest and fiduciary duty.

Overview and History. Mr. Doyle provided a brief background of the DOL fiduciary rulemaking. He outlined extensive changes that the DOL's pending proposed rule would make to the current five-part test under ERISA governing whether a person is a fiduciary that has been in place since 1975. He noted that the DOL first proposed a rulemaking that would make dramatic changes to the definition of fiduciary in 2010. The proposal was opposed strenuously by insurance, broker-dealer and other interests and the proposal was withdrawn in September 2011. The DOL then re-proposed the rule in April 2015. In addition to altering the definition of fiduciary (e.g., by proposing to delete the current "on a regular basis" prong and replacing it with one-time investment advice), the current proposal also would change numerous prohibited transaction exemptions ("PTEs"). The proposed rule would require fiduciaries to act "solely in the interest" of a plan, plan fiduciary, plan participant or beneficiary. Under the proposal, many additional persons would be deemed to be fiduciaries, including those who provide: (a) investment advice to plans and IRAs; (b) recommendations on the advisability of acquiring, holding, disposing of, or exchanging securities (including rollovers); (c) recommendations relating to the management of securities or other property; (d) appraisals, fairness opinions and similar statements; and (e) recommendations regarding the selection of investment advisers or other fiduciaries.

Regulatory Process. Mr. Campbell discussed the process DOL has followed since re-proposing its fiduciary rule and noted that there is a significant difference between DOL's "soaring rhetoric" and the "legal realities" of the proposed rule. He anticipates that the DOL will be releasing the final rule in the spring of 2016. Mr. Campbell outlined legislation that has been introduced in the House and Senate to delay or extinguish the DOL's final rule, but noted that such legislation would likely be vetoed by the President (and that it would be difficult to achieve a two-thirds vote in both the House and Senate to override any veto). A legal challenge to the final rule is likely and that there are multiple substantive and procedural grounds for such challenges.

Implications of the Proposed Rule. The panel discussed the extensive effects that the DOL rule would have on current practices, including: (1) counterparty (sales) transactions for plans that have more than 100 beneficiaries (Mr. Doyle stated that the DOL may include smaller plans in the final rule); (2) swap and securities-based swaps transactions; (3) employee communications with a plan fiduciary; (4) platform providers that provide securities selection and monitoring assistance; (5) providing appraisals, fairness opinions and similar statements for ESOPs and CITs; and (6) providing investment education. The panel also discussed the so-called best interest contract (BIC) exemption, which would eliminate the ability of brokers and others to receive commissions unless they comply with numerous requirements that some have described as "unworkable." These include having a written contract, agreeing to be bound by the best interest standard as a fiduciary, providing various warranties, and making extensive and ongoing disclosures regarding compensation.

The panel discussed the potential practical implications for asset managers, including possible effects on call-in and walk-in centers providing asset allocation or investment matching information, assisting in plan menu selection decisions, discussing rollover considerations, and other tailored or targeted communications regarding the investment of securities or IRA rollovers.

Preparations for the Final Rule. The panel discussed what asset managers and other securities professionals should do to prepare for the final rule. Panelists agreed that asset management firms have a variety of options to consider in adapting to the new rule. These include whether the firm will seek to rely on the proposed BIC exemption, whether to pursue a strategy of avoiding being designated a fiduciary by making no "recommendations," whether to exit the small plan or IRA rollover businesses, or whether to convert to level fee programs. While it is likely that the DOL will make changes to the current proposal before issuing its final rule, Mr. Campbell expressed skepticism that the changes would cure what he described as "fundamental flaws" in the proposed rule.

SESSION 3-E

Is the Sky Falling? The Shifting Role of Liquidity Risk Management and Regulation

Moderator: Dorothy M. Donohue, Deputy General Counsel, Securities Regulation, Investment Company Institute

Speakers: Sean Collins, Senior Director, Industry and Financial Analysis, Investment Company Institute

William G. De Leon, Managing Director, PIMCO

Ruth S. Epstein, Partner, Stradley Ronon Stevens & Young, LLP

Jasmin Sethi, Vice President, BlackRock, Inc.

Sarah G. ten Siethoff, Assistant Director, Rulemaking, Division of Investment Management, U.S. Securities and Exchange Commission

The panel discussed the implications of proposed Rule 22e-4 requiring open-end funds to, inter alia, implement a liquidity risk management program and comply with related disclosure and reporting requirements.

Proposal Overview and Industry Commentary. Ms. Epstein opened the panel with an overview of the proposal, noting that it seeks to reduce the risk that open-end funds will be unable to meet shareholder redemptions. In making its proposal, the SEC staff found that many fund complexes already have liquidity risk management programs, and that proposed Rule 22e-4's requirement that all open-end funds other than money market funds adopt such program, unlike other aspects of the proposed rule, has received broad support from commenters.

Ms. Epstein then provided an overview of the rule and the proposed requirements that funds categorize their holdings into one or more of six categories based on the number of days the funds estimate such holdings can be converted to settled cash and that funds establish and publish a three-day liquid asset minimum. She observed that these requirements elicited a substantial number of critical comments. Mr. De Leon said that the degree of precision in the proposed 6-category approach would require an extremely large amount of work, and would give investors a false sense of confidence in highly subjective categorizations. He then explained that PIMCO proposed a 3-category approach that would limit the degree of subjectivity in these determinations. Ms. Sethi echoed the concerns that categorizations would be highly subjective, and unlikely to yield consistent, comparable results across fund complexes. She said that BlackRock recommended the adoption of a liquidity tiering system premised on the view that liquidity is a continuum.

Mr. De Leon expressed the view that liquidity management is an integral part of portfolio management. He said that PIMCO establishes an internal daily minimum liquidity target for each fund based on its reasonably anticipated redemptions and margin calls. Ms. Sethi noted that the proposed rule appeared predicated on an assumption that a fund facing redemptions would seek to liquidate its most liquid positions first, while risk management considerations would suggest maintaining the fund's overall liquidity profile. She argued that the proposed rule's focus on a fund's ability to liquidate its entire position, rather than a normal trading lot, may be misleading to the extent it suggests that larger funds are necessarily less liquid. Mr. Collins added that the focus on a fund's overall position size might impede the comparability of liquidity assessments across fund complexes, as larger funds would be more likely to split their positions into different liquidity categories. Ms. ten Siethoff stated her belief that it is generally easier to trade small numbers of round lots than large numbers of round lots, but noted that the SEC staff would consider alternatives that commenters might suggest to address these concerns in the final rule.

Mr. De Leon questioned the proposed rule's focus on a fund's ability to liquidate a security at a price that does not materially affect the value of that asset immediately prior to sale, noting that values frequently change overnight due to security-specific or macroeconomic factors. Ms. ten Siethoff acknowledged that this issue had drawn many comments, and stated that the final rule would need to address the link between price and liquidity, as securities that can be sold only at "fire sale" prices aren't really liquid, but that normal bid-ask spreads shouldn't pose a problem.

In response to comments that the industry would have preferred a broad, high-level approach similar to than employed in Rule 38a-1, Ms. ten Siethoff argued that Rule 38a-1 was essentially an overlay on previously-existing regulatory requirements, while there is no separate underlying requirement with respect to liquidity. She stated that one of the issues with the current 15% limit on illiquid securities has been the absence of any factors required to be considered, making the test entirely subjective. The panel discussed the significant differences in equity and fixed income market structures, noting that, because most fixed income securities don't trade as frequently as equity securities, certain of the factors that the proposed rule would require to be considered, including average daily trading volume, might not be relevant. Ms. ten Siethoff acknowledged these differences and stated that the SEC staff expected funds would weigh factors differently in assessing the liquidity of different types of securities.

Implementation. Mr. De Leon reported that many vendors have been developing solutions intended to help firms meet the requirements of the proposed rule, and questioned whether a fund adviser could discharge its fiduciary responsibilities without considering liquidity as part of its portfolio management process. In response to a suggestion that the SEC staff might better ensure consistency by performing and publishing its own liquidity analyses of funds or by designating a single vendor to do so, Ms. ten Siethoff stated that firms actually trading portfolios on a daily basis would generally be better positioned than the SEC staff or a vendor to assess portfolio liquidity.

Information Gathering. Ms. Epstein noted that the proposed rule would require funds to report the categorization of each holding monthly on Form N-PORT, and that the report for the third month of each fiscal quarter end would be made publicly available on a 60-day lag. She added that many commenters, including strong advocates of disclosure such as Morningstar, had expressed concern that these public disclosures would confuse investors and potentially lead to a false sense of confidence. Ms. ten Siethoff acknowledged the risk of investor confusion, but stated that the SEC and its staff have had an historical presumption in favor of disclosure.

GENERAL SESSION

"Nudging" Better Behavior

Speaker: Nancy B. Rapoport, Acting Executive Vice President and Provost, UNLV, Garman Turner Gordon Professor of Law, UNLV Boyd School of Law, University of Nevada

This speaker discussed ways in which participants could consider how social science impacts the ethical practice of law to improve organizations.

Ms. Rapoport opened by asking attendees what they would change if they could change one thing about their firm. She described how, in seeking to change behavior, one needs to look at the incentives for the behavior. She noted that humans tend to want the thing that their culture celebrates and that an individual's desire for this thing will drive his or her behavior. Through the use of interesting and often humorous examples, Ms. Rapoport demonstrated how an organization must tailor incentives towards the outcome it wants to achieve. In this regard, she noted that studies have shown that people are motivated by incentives, and that people dislike having an incentive removed twice as much as they like one being given. She advised that organizations can skillfully use incentives to shape behavior.

Ms. Rapoport described her work as an examiner of law firm fees in bankruptcy cases and discussed cultural and behavioral changes that organizations can make to help them run more ethically and, arguably, more profitably. Through numerous examples involving the Enron case, Ms. Rapoport described certain red flags that firms might wish to consider such as: whether an attorney submits his or her timesheets in a timely manner; his or her commitments (or lack thereof) to mentoring and other firm activities; and any disciplinary action or sanctions by bar associations or similar entities. She noted that, when viewed in isolation, these items often don't seem like red flags, but, she noted, when viewed in hindsight, these behaviors are often indicative of someone who might not be conducting himself or herself with the highest of ethical standards.

Ms. Rapoport then discussed organizational culture and described ways in which firms can "nudge" better behavior. For example, she stated that certain tasks or protocols can be set up as opt-out instead of opt-in (i.e., all attorneys must do certain number of pro bono hours per year unless they affirmatively opt out and, if so, they need management approval). As part of this discussion, Ms. Rapoport illustrated the principle of "cognitive dissonance" and showed how social pressure at certain levels can actually impact responses that individuals give on a test. For example, one tends to doubt one's response when the group selects another, albeit incorrect, response. She underscored the importance of a group's opinion on an individual's behavior and stressed that, when done mindfully, the influence of a group on an individual can create more ethical behavior.

Ms. Rapoport discussed steps that an organization can take to frame behavior. First, an organization can create charts that set forth the firm's structure and describe (through a mission statement or otherwise) the behavior it expects of its members. The second step is political (i.e., identifying who at the firm has the power to enforce the structure). She noted that a key aspect of the tone at the top is mentoring and succession planning. Third, she explained, the investment that a firm makes in its people can to be designed so that individuals feel that they are part of the organization and those they, on an individual level, subscribe to the firm's ideals. Finally, a symbolic factor is how the firm's members see themselves.

GENERAL SESSION

Alert Level Red, Yellow, or Green: Putting Current Industry Topics into Perspective

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

Speakers: Andrew J. Donohue, Chief of Staff, U.S. Securities and Exchange Commission

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

Heidi W. Hardin, General Counsel, Harris Associates L.P.

Susan M. McGee, President and General Counsel, U.S. Global Investors, Inc.

Karrie McMillan, Managing Director, Patomak Global Partners, LLC

Thomas M. Mistele, Chief Operating Officer, Senior Counsel and Director, Dodge & Cox

Robert G. Zack, Independent Director, ARK ETF Trust

This panel discussed how current industry topics may impact the investment industry in the coming year. In particular, the panel addressed the impact of the SEC's "distribution in guise" sweep exam and financial intermediary oversight, the SEC's increasing use of IM Guidance Updates, and regulation through enforcement, and the SEC's liquidity risk management rule proposal.

Distribution in Guise and Financial Intermediary Oversight. The panel noted that the SEC's distribution in guise sweep exam had been a frequently discussed topic over the past few years and that the exam had resulted in the settlement of an enforcement action brought against First Eagle Investment Management, LLC and, more recently, a Wells Notice issued by the SEC to William Blair & Company, L.L.C. ("WBC"), informing WBC that the SEC staff intended to recommend an enforcement action against WBC to the SEC Commissioners.

The panel also discussed a fund adviser's and board's role in overseeing financial intermediaries and the costs and difficulties associated with obtaining and reviewing the type of information the SEC staff cited in the Distribution in Guise Guidance. Mr. Mistele said that fund boards needed further guidance as to what due diligence and oversight they were expected to perform, and Ms. McMillan noted the significant financial impact that increased intermediary oversight would have on smaller asset management firms.

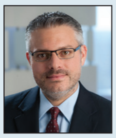
IM Guidance Updates and Regulation through Enforcement. The panel discussed DIM's recent use of IM Guidance Updates to communicate its views on regulatory issues. Concern was expressed that these updates were not subject to the formal rulemaking process. The panel also discussed recent SEC enforcement actions, which the panelists felt were not particularly useful in providing clear guidance to funds and advisers. It was also noted that there was some concern that the SEC staff had attempted to expand upon the scope of Rule 38a-1 under the 1940 Act in the April 2015 BlackRock Advisors enforcement action.

Liquidity Risk Management Proposal. The panel also discussed the SEC's proposed rules regarding mutual fund liquidity risk management, including the potential implementation of "swing pricing." The panelists generally agreed that requiring some form of written liquidity risk management program for mutual funds was prudent. The panelists expressed some concerns regarding the operational challenges associated with implementing swing pricing and the lack of predictability that could result from the non-universal adoption of swing pricing.

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

Edward Baer
Counsel—San Francisco
edward.baer@ropesgray.com
+1 415 315 6328

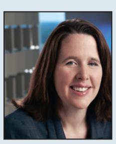
Sarah Clinton
Partner—Boston
sarah.clinton@ropesgray.com
+1 617 951 7375



Timothy F. Cormier
Counsel—Boston
timothy.cormier@ropesgray.com
+ 1 617 951 7747

Sarah Davidoff
Partner—New York
sarah.davidoff@ropesgray.com
+1 212 596 9017

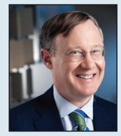
Michael Doherty
Partner—New York
michael.doherty@ropesgray.com
+1 212 497 3612



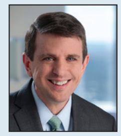
Leigh R. Fraser
Partner—Boston
leigh.fraser@ropesgray.com
+1 617 951 7485

Pamela L. Glazier
Partner—Boston
pamela.glazier@ropesgray.com
+1 617 951 7420

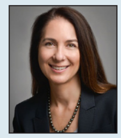
Thomas R. Hiller
Partner—Boston
thomas.hiller@ropesgray.com
+1 617 951 7439



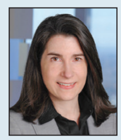
John M. Loder
Partner—Boston
john.loder@ropesgray.com
+1 617 951 7405



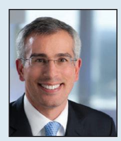
Brian D. McCabe
Partner—Boston
brian.mccabe@ropesgray.com
+1 617 951 7801



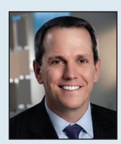
Kathleen Nichols
Senior Attorney—Boston (Remote)
kathleen.nichols@ropesgray.com
+1 617 854 2418



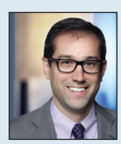
Rita Rubin
Counsel—Chicago
rita.rubin@ropesgray.com
+1 312 845 1241



Adam M. Schlichtmann
Partner—Boston
adam.schlichtmann@ropesgray.com
+1 617 951 7114



Robert Skinner
Partner—Boston
robert.skinner@ropesgray.com
+1 617 951 7560



Jeremy C. Smith
Partner—New York
jeremy.smith@ropesgray.com
+1 212 596 9858

David Sullivan
Partner—Boston
david.sullivan@ropesgray.com
+1 617 951 7362

David Tittsworth
Counsel—Washington, D.C.
david.tittsworth@ropesgray.com
+1 202 508 4722

OUR OFFICES WORLDWIDE

NEW YORK
1211 Avenue of the Americas
New York, NY 10036

T +1 212 596 9000
F +1 212 596 9090

CHICAGO
191 North Wacker Drive
32nd Floor
Chicago, IL 60606

T +1 312 845 1200
F +1 312 845 5500

HONG KONG
One Exchange Square
41st Floor
8 Connaught Place
Central, Hong Kong

T +852 3664 6488
F +852 3664 6588

WASHINGTON, D.C.
2099 Pennsylvania Avenue, NW
Washington, DC 20006

T +1 202 508 4600
F +1 202 508 4650

SAN FRANCISCO
Three Embarcadero Center
San Francisco, CA 94111

T +1 415 315 6300
F +1 415 315 6350

SHANGHAI
36F, Park Place
1601 Nanjing Road West
Shanghai 200040

T +86 21 6157 5200
F +86 21 6157 5299

BOSTON
Prudential Tower
800 Boylston Street
Boston, MA 02199

T +1 617 951 7000
F +1 617 951 7050

SILICON VALLEY
1900 University Avenue
6th Floor
East Palo Alto, CA 94303

T +1 650 617 4000
F +1 650 617 4090

SEOUL
POSCO P&S Tower, 21F
134 Teheran-ro, Gangnam-gu
Seoul 06235

T + 82 2 2141 5900
F + 82 2 2141 5950

LONDON
60 Ludgate Hill
London EC4M 7AW

T +44 20 3201 1500
F +44 20 3201 1501

TOKYO
JP Tower 30F
2-7-2, Marunouchi
Chiyoda-ku, Tokyo 100-7030

T +81 3 6259 3500
F +81 3 6259 3501

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