Bearmoor, LLC

Asset Management and Fiduciary Consultants

Regulatory Update
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Introductory Comment: In this edition I am presenting two recent speeches; one given by SEC Chairman Christopher Cox and the other by Federal Reserve Chairman Ben Bernanke. These two speeches provide us insight into the key areas of focus by these to regulatory agencies. The direction and guidance provided in their comments should assist you and your organization to better understand the regulatory environment in which we operate. Also, I have included information on "soft dollar" guidance; ICI's response to cross trading policies and procedures, and EBSA request for comment on 401(k) fee disclosures.

SEC: Speech by SEC Chairman Christopher Cox to the Mutual Fund Directors Forum Annual Policy Conference

Background

On April 13, 2007 SEC Chairman Christopher Cox gave a speech at the seventh annual Mutual Fund Directors Conference. In his speech, Chairman Cox highlighted and outlined the areas where the SEC will be focusing during 2007. He devoted a large portion of his speech addressing the need to begin to make changes with Rule 12b-1. He indicated that the purpose of Rule 12b-1 has long been achieved, and that the continued use of 12b-1 fees to pay brokerage commissions needs to be changed. He also spoke of the need to ensure that effective mutual fund fee disclosures are provided, especially in the defined contribution environment. In addition he spoke of the need to continue to review the use of "soft dollars" and proper investor disclosure. Below is an excerpt from Chairman Cox's speech.

Information – Excerpts from Speech

Eight years into your mission, good governance of the mutual fund industry has never been more important. With more than $10 trillion in assets, mutual funds have replaced the savings accounts of old as the primary long-term savings vehicle for almost half of all American households. As a result, insuring that investors can have confidence in the way their mutual funds are managed is key to maintaining confidence in our financial system.

As independent directors, you play a critical part in the stewardship of this industry. I greatly appreciate and thank you for your commitment to the important work of protecting mutual fund investors. You have helped us in so many different areas that are critical to investor protection - not least of all with respect to 12b-1 fees, which, as you know, the Commission is closely examining this year.

When the Commission adopted Rule 12b-1 more than a quarter century ago, our premise was that 12b-1 plans would be relatively short lived. The idea was that 12b-1 fees would be used to solve specific distribution problems, as they arose. And indeed, in the early going, that was our experience. No-load funds used 12b-1 fees of 25 basis points or less to offset the costs of advertising, of printing and mailing prospectuses, and of printing and mailing sales literature.

All of this was consistent with the Commission's purposes in adopting the rule, at a time when nurturing mutual fund growth was an SEC priority. Specifically, the Commission's action came at a time of net redemptions. There was a very real concern that if funds were not permitted to use at least a small portion of their assets to facilitate distribution, many of them might not survive.

Very quickly, however, 12b-1 plans came to be used for other reasons. Most notably, instead of paying for distribution, they became a substitute for front-end loads. In this way, more substantial sales loads could be collected while the fund could still advertise itself to investors as "no load." The transformation of the 12b-1 fee from a distribution subsidy to a sales load in drag is now so nearly complete that the primary purpose to which the $11 billion in 12b-1 fees last year were put was to compensate brokers.

Another way that 12b-1 fees have veered away from their conceptual basis as distribution subsidies has been using them to pay for administrative expenses in connection with existing fund shareholders. Even some funds which are closed to new investors continue to collect 12b-1 fees.

So it is that today, by far the lion's share of mutual funds' 12b-1 fees are used for these two purposes. Back in 1980, the Commission noted in our adopting release that we and our staff would monitor the rule's operation closely. And if experience suggested that the rule's restrictions on the use of fund assets were insufficiently strict, we made it clear we would be prepared to act to remedy the situation.

Now, with nearly three decades of experience under our belts - and with today's uses of 12b-1 fees barely recognizable in the light of the rule's original purpose - it is high time for a thorough re-evaluation. The considerable distance that 12b-1 fees have strayed from the rule's paradigm isn't just occasion for the Commission to take a hard look at current practices. It's also a reason for independent directors to take a fresh look at the way this use of investors' funds has evolved.

That's because Rule 12b-1 places considerable burdens on independent directors, without whose approval no payment may be made by a fund in connection with the distribution of its shares. Specifically, not just the fund's board, but a majority of the independent directors have to agree to the 12b-1 plan. And the rule imposes additional oversight duties on fund directors, including that each year, without fail, you're required to approve your fund's 12b-1 plan. One element of the plan you cannot leave out, or change, is that it may be terminated at any time by vote of a majority of the independent directors.

Rather obviously, the Commission had you in mind when the rule was devised. And if that weren't enough to make you feel intimately involved with the decision to collect 12b-1 fees, you are also required to periodically review all of the amounts that are spent in the name of the plan for which you are so personally responsible - and to satisfy yourself as to the reasons for those expenses.

In doing all of this, fund directors are held to the fiduciary standards set out in both Section 36 of the Investment Company Act, and in applicable state law.
Given that the Commission has so thoroughly bound the decision to charge 12b-1 fees to the independent judgment of the fund's disinterested directors, both we and you together have to tackle head-on the problem of brokers' sales commissions masquerading as fund marketing costs. It is worth revisiting, therefore, the original intent of Rule 12b-1, and considering its meaning in light of today's market realities and current practice.

What the SEC had in mind in 1980 is that requiring current investors to subsidize the sale of fund shares to new investors could be a good thing - even from the standpoint of the current investors - because increasing overall fund size could help better diversify their holdings, and also proportionally reduce the burden of administrative costs that might now be spread over a wider pool of investors. After all, higher expense ratios reduce investors' returns percentage point for percentage point.

But whether, in fact, a fund's current investors are getting a break depends upon how the investment advisory contract is written. If increasing the size of the fund simply enlarges the fees earned by the investment adviser, the supposed benefits from economies of scale are undone. So one of the things that independent directors must concern themselves with in reviewing the propriety of any 12b-1 fees used for distribution is whether the fees paid to the management company and other vendors, as a percentage of total fund assets, has risen or fallen as the fund has grown. If the size of the fund is increasing, but the expense ratio isn't falling, then using a 12b-1 fee for marketing and distribution expenses is very likely harming, not helping, the current investors.

There are other reasons to question the continued vitality of Rule 12b-1. Today the mutual fund industry is no longer at risk of suffering crib death, as was the case years ago when rule 12b-1 was adopted. At more than $10 trillion and counting, the survival of the mutual fund industry is plainly no longer at issue. Indeed, we have learned by this point in the 21st century that it can be just as big a problem for investors when a fund grows too large as when it is too small. The assumption can't always be made that growth in total assets inevitably assists existing investors. When funds grow too big, they can lose flexibility, with the result that investors get lower returns.

For all of these reasons, the original premises of Rule 12b-1 seem highly suspect in today's world. If ever it was justified to indulge an irrebuttable presumption in favor of using fund assets to compensate brokers for sales of fund shares, that time surely has passed. Collecting an annual fee from mutual fund investors that is supposed to be used for marketing is no more consumer friendly than forcing cable TV subscribers to pay a special fee of $250 a year so the cable company can advertise HBO and Showtime to lure potential new customers.

In meeting the fiduciary standards of the Investment Company Act and state law, of course, independent directors have to focus on the investors whose interests they represent. And so the independent directors' decision whether to approve a 12b-1 plan, and payments out of fund assets made pursuant to the plan, has to be no unless existing shareholders will benefit. Ironically, the strongest case for saying yes might well be when the 12b-1 fee is used to pay not for distribution, but for administrative services that are far afield from the kinds of costs that the original rule had in mind. After all, there is no question that processing shareholder transactions, maintaining shareholder records, and mailing account statements, fund communications, and reports to shareholders are services delivered to current investors - not potential new ones. That is at least a tangible something, as opposed to paying a commission to a broker. And it has a basis in some of the exemptive orders that have been issued over the years. But to the main point, it is a very different something than the rule itself contemplated when it was first adopted.

That is why Rule 12b-1 is an issue the Commission will address this year. And as we do so, we will have the interests and concerns of independent directors, whose responsibilities and sensitivities to the fund's investors are thought to be particularly acute, uppermost in our minds.

Nor is that all that the Commission will be doing this year that will be of direct interest to you. We intend to re-propose and then finalize our mutual fund governance rule. As you know, the comment period recently ended on the economic studies that were done in connection with the rule as it was first proposed - before its invalidation in the court of appeals. We are reviewing these comments carefully, analyzing them in the context of a comment file that now spans almost four years and includes more than 14,000 letters -including the thoughtful comments submitted by the Forum. We will punctiliously observe the procedural requirements to which the court directed us, and we will complete that important business with due regard for the comments already submitted, and those yet to be received.

We are also in the midst of a broad initiative to examine the adequacy of investor disclosures by mutual funds and other investment vehicles in a typical 401(k) plan. With an emphasis on both the disclosures by the constituent investments in the 401(k), and the aggregate disclosures by the plan, we aim to make it far easier for busy Americans to understand the expenses they're being charged in connection with their investments, and the after-tax, after-inflation returns they're actually getting compared to an appropriate index. Even though this will require collaboration with the Department of Labor and other investment regulators, we're confident we can achieve a great deal in the coming months - and that the effort is supremely worthwhile, given what's at stake.

The historic shift from company-guaranteed pension plans to investor-directed vehicles such as 401(k) plans and other defined contribution retirement plans has put this issue at the center of our radar. Americans no longer can count on conventional pensions for support during their increasingly long retirement years. Defined benefit plans are going the way of the 8-track tape. So applying yourself diligently all of your working life won't mean retirement. It will mean a new career as a do-it-yourself money manager.

Every American worker and every American family potentially are affected. And, as a nation, we've got to get this right, because an America burdened by large numbers of elderly living in straitened circumstances will not be a happy place, and the resulting problems will manifest themselves in countless dysfunctional ways.

Our current arrangements, however, fall tragically short. To far too great a degree, and in substantial part because of a regulatory cumbersomeness that obscures the real numbers, our financial services industries are able to skim off much more of the assets they handle than would be the case in a well-functioning market. The difference materially burdens an investor's annual expected returns. And compounded over the retirement time horizon of even someone in his or her 50s, this can result in truly astronomical shortfalls.

This is happening even now on a nationwide basis. That's why you can be sure that the "investors advocate" will be tackling this issue for the benefit of not only our senior citizens, but today's young savers as well.

Americans already invest well over $3 trillion through these defined contribution retirement plans. And as I'm sure you know, nearly half of that is in mutual funds. And with the number of elderly Americans expected to grow 80% within the next 25 years, these already eye-popping numbers will grow further still. We want to be sure that today's retirees, and tomorrow's, have the information they'll need to successfully manage their savings through a retirement that, actuarially speaking, is guaranteed to be far longer than their parents'. So to insure we get the job done sooner rather than later, in the coming months we'll hold roundtable discussions with the nation's leading experts, and publish a concept paper outlining the issues we're addressing and the solutions that have been suggested. That, in turn, will pave the way for a formal rule proposal later this year.

In this process, we'll be building on a substantial record that has already been compiled, including at our SEC Roundtable last June. From the input of investor advocates, third-party users of fund disclosure, fund directors such as yourselves, and others, a strong consensus emerged for the creation of more succinct, easy-to-understand disclosure documents for investors that highlight the key information about mutual funds that is most important to investors. The Commission's staff is already working on proposals to create this streamlined disclosure document for investors. Along with the improved presentation, those proposals may also call for better and more detailed information about investment objectives, strategies, risks, and costs, which could be made available online or in writing, as the investor prefers.

And while we're doing this we'll continue to work to purge all of the legalese from these disclosures, and convert them into plain English. Getting rid of gobbledygook is no easy task, of course. After all, it isn't just legalese that has problems - even ordinary English often needs improvement. Just ask yourself: why is "abbreviated" such a long word?
So we'll stay at it. And at the same time, we'll be examining the different types of disclosure that 401(k) participants receive, which today vary from full prospectuses and shareholder reports to one-page charts that contain extremely limited information. Our goal, working with our fellow regulators, is to develop an approach to 401(k) disclosures that permits each investor to obtain the information necessary to inform a sound investment decision.

Nor will we stop there.

Your organization has consistently focused on the significant conflicts of interest that fund directors face in connection with soft dollars, and the Commission plans more work here, as well.

Soft dollars can serve as an incentive for fund managers to disregard their best execution obligations, and also to trade portfolio securities inappropriately in order to earn credits for research and brokerage. Soft dollars also represent a lot of investors' hard cash, even though it isn't reported that way. The total of soft dollars runs into the billions each year for all investment funds in the United States.

An agency focused on ensuring full disclosure to investors has to be very concerned about this, because soft dollars make it more difficult for investors to understand what's going on with their money. Hard dollars eventually end up being reported as part of the management fee the fund charges its investors. But soft dollars provide a way for funds to lower their apparent fees - even though, in the end, investors pay for the expense anyway.

The very concept of soft dollars may be at odds with clarity in describing fees and costs to investors. The 30-year old statutory safe harbor, in Section 28(e) of the Exchange Act, was probably thought to be a useful legislative compromise when it was packaged with the abolition of fixed commissions. But surely in enacting Section 28(e) Congress meant to promote competition in research, not to create conflicts of interest by permitting commission dollars to be spent in ways that benefit investment managers instead of their investor clients.

That is why the Commission is continuing to examine the potentially distortive effects that soft dollars can have on what should be the normal market incentive to seek best execution. And we're looking to ensure that when soft dollars are used to pay for research, it doesn't interfere with the full disclosure of actual management costs. In particular, the Commission will consider whether fund boards could better assess soft dollar arrangements if the Commission were to mandate better disclosure of the research and brokerage services that the adviser gets in return for a bundled commission. If directors are able to compare the broker's execution-only commission rate with its bundled rate, they could make more meaningful inquiries into the value of the additional services that the fund shareholders are getting.

Our recent interpretive guidance was a step forward in this area, but it may not be enough to wipe out the abuses that the Commission has discovered, such as soft dollars used to pay for membership dues; carpeting; entertainment and travel expenses; and lavish expenditures for interior decorators and beachfront villas. So while the Commission's soft dollar release was important, you can rest assured it won't be our last word on this subject.

Again, I want to commend each of you, and this organization, for your leadership in this area. I look forward to our continued work together.

As you almost certainly know by now, no speech of mine, whether short or long, would be complete without a mention of interactive data. And because of the leadership that the mutual fund industry has shown, my mentioning it in this context is a very pleasant opportunity. Earlier this year, the Commission issued a proposing release requesting comment on whether mutual funds should now begin to use interactive data to report the information in the risk/return summaries. Since these summaries include a fund's investment objectives as well as its strategies, costs, risks, and historical performance, letting investors and analysts easily use and compare this data has the potential to vastly improve the quality of information that's provided to mutual fund investors.

Your industry's participation in the Commission's interactive data initiatives has been truly exemplary. The truth is, as independent directors, you share more than just our goals at the Commission. An article in today's paper reminded me that not only are we partners in our mission of investor protection, but also the way the law expects us to execute our roles gives us similarly weighty responsibilities.

Like you, each of the five Commissioners of the SEC shares the duty of overseeing and monitoring the operations and activities of our organization. Under procedures established long before I became Chairman, no formal investigation is initiated, no case is filed, no settlement is agreed to without Commission approval. Each of us has been appointed by the President and confirmed by the Senate with the express understanding that, like you, we will be independent in our actions and our judgments, with only the welfare of the nation's investors and markets as our special interest.

Nowhere is this more important than in the area of enforcement, where - as we saw in the mutual fund scandals of 2003 and 2004 - vigorous Commission action is necessary to ensure that a culture of ethics and compliance operates throughout a fund complex for the benefit and protection of the funds' investors. At the same time, Commission review of enforcement actions shouldn't slow down the process. As both the Commission's caseload and its staff have grown in recent years, that has posed a genuine tradeoff for Commissioners seeking to fulfill their fiduciary duty.

What full Commission review should provide is a guarantee of fairness and of horizontal equity in a nationwide program. And it should be the wind at the backs of our staff across the country as they seek to obtain the best possible results for America's investors. When enforcement lawyers in settlement discussions sit eye-to-eye across the table from counsel for the defense, we want them to know they have the full backing of the Commission. Our staff will have the strongest negotiating

position, of course, if the Commission has reviewed the proposed range of outcomes before the offers in settlement are made. So in a handful of cases where the need for national consistency is greatest, we're reviving what had been a long standing policy of the SEC for all cases for many years - that Commission approval be obtained before settlement discussions are commenced. But we'll do so with a difference: When cases are settled within the range of guidance provided by the Commission, they will be eligible for summary approval through the Commission's seriatim procedure. And I and each of the Commissioners are committed to seeing to it that this procedure works to speed up, not slow down, our cases.
The category of cases we've selected consists of those in which a monetary penalty against a company might be involved. As you know, very recently the Commission adopted new guidelines for cases of this kind, and we are anxious to ensure that in the early days of its implementation, the precedents we establish are clear, consistent, and in accordance with the instructions of Congress in the Remedies Act. Already, there's been speculation whether this procedural change portends a shift to higher or lower penalties. It is, of course, designed to do neither, but rather to ensure that the laws are vigorously enforced with the benefit of full Commission review.

But if I had to hazard a guess, it would be that if anything, the penalties you will see imposed in future cases will be stiffer - because the staff lawyers negotiating them won't have to hedge their bets, wondering whether the Commission will later on back them up, or rather cut them off at the knees. We should never put our staff in such a position. They are America's finest, and every Commissioner is extremely proud of the work they do. We're confident that this new approach will give them more flexibility and better tools to do their jobs more effectively and more quickly. It will also give each of the Commissioners a better opportunity to do our jobs, which require of us the same oversight responsibilities that each of you must constantly exercise as independent directors.

We have much to learn from working with you. And because the key to any good partnership is communication, I and each of the Commissioners have been actively reaching out to fund directors to engage in a dialogue. I plan to continue to meet personally with members of mutual fund boards, because you know from first-hand experience what SEC regulators can do that would make a positive impact in your work. You best understand the funds you oversee and your shareholders' expectations; you are the ones who are called upon to make determinations about fund fees and operations; you routinely interact with fund management and have intimate knowledge of not only the funds, but also their service providers and personnel.

That is why we need you to partner with us to make sure the mutual fund industry meets the highest possible standards for investors. We need you to help us in constantly enhancing oversight. Ultimately, investors are depending on you to get the answers, to require accountability, and to ensure fairness and integrity in the conduct of the funds' business. Their investments are in your hands. You have a truly important responsibility, to our nation and its citizens, and we at the SEC have every confidence that you are up to the challenge.

Thank you for inviting me, and more importantly, thank you for what you do every day. We at the SEC are proud to be your partners.

FRB: Remarks by Chairman Ben Bernanke at the Federal Reserve Bank 2007 Financial Markets Conference – Regulation and Financial Innovation

Background
On May 15, 2007 Federal Reserve Board Chairman, Ben Bernanke provided a speech to the Federal Reserve Bank of Atlanta's 2007 Financial Markets Conference. His comments focused on regulation and financial innovation. In his remarks Chairman Bernanke addressed, from the 30,000-foot level, the challenges that financial innovation poses for public policy and the nature of the appropriate regulatory response. He argued that central banks and other regulators should resist the temptation to devise ad hoc rules for each new type of financial instrument or institution. Rather, the Federal Reserve Board should strive to develop common, principles-based policy responses that can be applied consistently across the financial sector to meet clearly defined objectives.

Information – Excerpt from Speech

Good morning. I'm pleased to be able to join you for this year's financial markets conference, albeit from afar. Last year the focus was on hedge funds, and the main theme of this year's gathering is credit derivatives. This pairing makes eminent sense, in that the increasing prominence of hedge funds and the growth of the market for credit derivatives are both aspects of the remarkable wave of financial innovation that we have seen in recent years. Both of these developments have also been the subject of public policy debates, including calls for increased regulation. In my remarks today I will address, from the 30,000-foot level, the challenges that financial innovation poses for public policy and the nature of the appropriate regulatory response. I will argue that central banks and other regulators should resist the temptation to devise ad hoc rules for each new type of financial instrument or institution. Rather, we should strive to develop common, principles-based policy responses that can be applied consistently across the financial sector to meet clearly defined objectives.

In addressing the challenges and the risks that financial innovation may create, we should also always keep in view the enormous economic benefits that flow from a healthy and innovative financial sector. The increasing sophistication and depth of financial markets promote economic growth by allocating capital where it can be most productive. And the dispersion of risk more broadly across the financial system has, thus far, increased the resilience of the system and the economy to shocks. When proposing or implementing regulation, we must seek to preserve the benefits of financial innovation even as we address the risks that may accompany that innovation.

Clear thinking is therefore essential. In developing a regulatory framework, we need to be explicit both about what the public policy objectives of regulation are and about how, if at all, fresh developments threaten to undermine those objectives. We should also take into account the role that the market itself can play in controlling risks to public objectives; as I noted last month, market discipline can be an important element in a well-functioning regulatory scheme. And as I have already observed this morning, any regulatory changes should fulfill the test of consistency, across both institutions and instruments.

Ensuring a Consistent Approach

In thinking about how, or whether, to regulate innovative financial institutions (such as hedge funds) or instruments (such as credit derivatives), we should be wary of drawing artificial distinctions. Are the characteristics of hedge funds or credit derivatives that arouse concern peculiar to these institutions and instruments, or are they associated with others as well? If the characteristics in question are in fact a feature of the broader financial landscape, then a narrowly focused approach to regulation will be undermined by the incentives such an approach creates for regulatory arbitrage.

For example, while the complexity of new financial instruments and trading strategies is potentially a concern for policy, as I will discuss, not all credit derivatives are complex and--to state the obvious--not all complex financial instruments are linked to credit risk. Single-name credit default swaps and credit default swap indexes are relatively simple instruments, whereas derivatives based on other asset classes--such as exotic interest-rate and foreign-exchange options--can, by contrast, be quite complex. Moreover, derivatives in general are not necessarily more complex than some types of structured securities. In short, if complexity per se is the concern, we cannot address that concern by focusing on a single class of financial instruments. Similarly, hedge funds are hardly a homogeneous group of institutions, nor can their trading strategies be unambiguously distinguished from those of large global banks or of some traditional asset managers. A consistent regulatory strategy needs to be tailored to the essential characteristics of institutions or instruments that pose risks for policy objectives, not to arbitrary categories.

At last year's conference, I discussed a policy proposal focused narrowly on hedge funds--namely, the development of a database of hedge fund positions and portfolios. As I noted last year, given the complexity of trading strategies and the rapidity with which positions change, creating a database that would be sufficiently timely and detailed to be of practical use to hedge funds' creditors and investors or to regulators would be extremely difficult. Collecting such information also risks moral hazard, if some traders conclude that, in gathering the data, the regulators have somehow reduced financial risk.

The principle of consistency on which I am focusing today raises an additional objection to this proposal, which is that it would make little sense to collect data on hedge funds' positions without gathering the same information for other groups of market participants that use similar strategies and take similar risks.

An analogous issue arises in the debate over transparency in the credit derivatives market. Some argue that policymakers should act to make trading in the credit derivatives market more transparent, on the grounds that the market and policymakers should know just who is holding the credit risk associated with a particular issuer. But if transparency about risk-bearing is important, then consistency seems to imply that full transparency should be required of credit markets broadly, not just of credit derivatives. And why stop with credit markets? Do we know exactly who is bearing the risk in equity markets or foreign exchange markets, for example?

Rather than addressing specific institutions or instruments in isolation, regulators should begin by identifying their objectives and then address the implications of the broad range of financial innovations for those objectives. By returning to the basics, we can increase the coherence, consistency, and effectiveness of the regulatory framework.

Public Policy Objectives

As public policymakers, we have three principal objectives in the financial sphere, objectives that have remained essentially unchanged over many decades even as the pace of financial innovation has accelerated. These objectives are financial stability, investor protection, and market integrity. These goals are widely shared by policymakers around the world and thus provide a basis for international cooperation.

From a central banker's point of view, the objective of ensuring financial stability remains critical. Indeed, the Federal Reserve was founded in large part because of concerns about periodic bouts of instability that damaged both the financial system and the broader economy. Policymakers cannot prevent financial shocks, but we can try to mitigate their effects by ensuring that the system remains fundamentally sound. In particular, as I will discuss, we can use our supervisory authority to ensure that the large institutions that form the core of the financial system--which happen to be the leading dealers in the credit derivatives markets and the principal counterparties and creditors of hedge funds--manage the risks that they face in a safe and sound manner.

Investor protection is another vital public objective. A loss of confidence in the financial system by investors, too, could undermine the system's stability and functioning. Of course, we cannot--and should not--prevent all investor losses. To avoid moral hazard and let market discipline work, investors must be allowed to bear the consequences of the decisions they make and the risks they accept. But investors are entitled to the information they need to make decisions appropriate to their personal circumstances.

Closely linked to the imperative of investor protection is the third public policy objective: preserving the integrity of the market. The stability and the efficiency of the market depend on a common understanding of and adherence to the rules of the game. Thus, policymakers must attach a high priority to preventing insider trading, market manipulation, and other activities that rig the game and undermine public confidence.

Challenges to Public Policy Objectives

The rapid pace of financial innovation creates challenges for policymakers with respect to each of these policy objectives. In particular, financial stability depends on adequate risk measurement and risk management by market participants. Failures of risk management by large institutions, or by a sufficient number of smaller ones, would threaten not only the solvency of the institutions themselves but also the health of the whole system.

Of course, in some respects financial innovation makes risk management easier. Risk can now be sliced and diced, moved off the balance sheet, and hedged by derivative instruments. Indeed, the need for better risk sharing and risk management has been a primary driving force behind the recent wave of innovation. But in some respects, new instruments and trading strategies make risk measurement and management more difficult. Notably, risk-management challenges are associated with the complexity of contemporary instruments and trading strategies; the potential for market illiquidity to magnify the riskiness of those instruments and strategies; and the greater leverage that their use can entail.

Complexity--especially when combined with illiquidity--amplifies the difficulty of measuring risk, both market risk and counterparty credit risk. For example, some complex instruments can be valued only with the aid of sophisticated modeling techniques. The problems of valuation and of risk measurement faced by investors in tranches of bespoke collateralized debt obligations (CDOs) are a good example. Similar problems are faced by the core financial intermediaries that often act as counterparties to hedge funds in complex synthetic CDO transactions or that finance hedge funds' investments in bespoke CDO tranches. Complex trading strategies and positions, too, can create problems. For example, counterparty risks may be underestimated because of failures to aggregate exposures to risks across instruments and counterparties. What is essentially the same risk can appear in different forms; for example, investments in a CDO tranche, a bond, and a credit default swap may all entail credit risk to a given obligor.

Illiquidity, or the potential for illiquidity under some conditions, is also a problem for managers of market risk and counterparty credit risk. Substantial market risk may be associated with holdings of illiquid instruments; again, tranches of bespoke CDOs illustrate this well. A pattern of crowded trades may lead to market illiquidity--sometimes in surprising locations--when risk aversion heightens. In particular, counterparty exposures can be significantly increased if the closeout of positions of one or more hedge funds by their dealer counterparties leads to, or exacerbates, market illiquidity.

Market liquidity depends not only on the presence of willing buyers and sellers but also on the underlying infrastructure, including market-making capacity and the system for clearing and settling financial transactions. Twenty years ago this fall, the 1987 stock market crash was significantly worsened by the inability of trade-processing systems to keep up with order flows, including orders resulting from program trading. Of course, automated trading is far more pervasive today, and overall trading volumes have expanded greatly. As trading volumes grow, market infrastructures must adapt. Until 2005, reliance on paper-based procedures for confirming trades in the rapidly growing credit derivatives markets sometimes resulted in large backlogs of unconfirmed trades, which increased the risks to market participants. With leadership from their prudential regulators, dealers in those markets have adopted electronic confirmation platforms and greatly reduced the backlogs. Currently, regulators and market participants are beginning to address large backlogs of confirmations in the equity derivatives markets.

The *leverage* that can be embedded in new financial instruments and trading strategies compounds the difficulties of risk management. Embedded leverage can be difficult to measure; at the same time, like conventional leverage, it may increase investor vulnerability to market shocks. Some credit derivatives do make it easier for investors to take leveraged exposures to credit risk. For example, the first-loss tranche of the investment-grade CDX credit default swap index is exposed to the first 3 percent of losses on the index portfolio. Holding a $3 million position in this tranche exposes an investor to losses on an underlying portfolio of $100 million. A dealer taking the other side of the trade obviously needs to enhance its counterparty risk-management practices to take this greater leverage into account.

Complexity, illiquidity, and embedded leverage also create challenges for policymakers with respect to the objectives of protecting investors and maintaining market integrity. If hedge funds and the large banks that are hedge funds' counterparties and creditors have difficulty assessing the risks associated with complex financial instruments, many investors will find gaining a sufficient understanding of the risks even more burdensome. Investors may also not appreciate the extent to which they may have multiple exposures to the same source of risk--for example, arising from effective exposures to the same hedge fund through funds of funds or from investments in different funds with similar trading strategies. Current restrictions on hedge fund investors, which limit direct investors to institutions or wealthy individuals, reflect the recognition of the difficulties that a retail investor would face in adequately assessing these types of risk. But as instruments and trading strategies become more complex and intertwined, even the most sophisticated investors will be challenged to make reliable judgments about their risk exposures. Likewise, complex and difficult-to-value financial instruments could be exploited as vehicles for profiting from insider trading or market manipulation, although, as history shows, simpler instruments can be used in this way as well. Policymakers must be confident of their ability to detect such market abuses when they occur.

A Principles-Based, Risk-Focused Approach

How best to respond to these daunting challenges? As I noted, there are powerful arguments against ad hoc instrument-specific or institution-specific regulation. The better alternative is a consistent, principles-based, and risk-focused approach that takes account of the benefits as well as the risks that accompany financial innovation.

Some commentators have sought to draw a sharp distinction between the approach to financial regulation in the United States and that in the United Kingdom. These observers have characterized the British approach as being principles-based and as using a "light touch"--the implication being that these two features somehow go together. In a speech in February of this year, Sir Callum McCarthy, the head of the United Kingdom's Financial Services Authority (FSA), took issue with this interpretation. Sir Callum confirmed that the FSA's approach is built on a framework of principles, although he noted that the FSA also has an 8,500-page rulebook to accompany the eleven principles it has laid out. But the FSA head rejected the view that their approach is "light touch." Rather, he said, it is risk-based, which means that regulatory resources and attention are devoted to firms, markets, or instruments in proportion to the perceived risks to the FSA's regulatory objectives.

In fact, as in the United Kingdom, the principles-based, risk-focused approach to regulation has had considerable influence on this side of the Atlantic as well. For example, as you may know, the President's Working Group on Financial Markets (PWG) recently issued a statement of principles--ten in this case--relating to the regulation of private pools of capital, including hedge funds. Our aim in presenting these principles was to spell out how a combination of market discipline and government oversight could be most effective in addressing the challenges to public policy objectives that I have described. The principles make clear that regulators and supervisors should adopt the risk-focused approach described by Sir Callum. In particular, they emphasize that risks to financial stability are best addressed by focusing our attention on the large institutions at the core of the financial system.

Some care is needed in applying a risk-focused approach to regulation, however. In particular, when the government singles out particular institutions or markets as being especially critical to the stability of the system, moral hazard concerns may well follow. A perception that some institutions are "too big to fail" may create incentives for excessive risk-taking on the part of those institutions or their creditors. For that reason, part of an effective risk-focused approach is the promotion of market discipline as the first line of defense whenever possible. Market discipline is enhanced whenever regulators take positive steps to ensure that investors and managers bear the consequences of their financial decisions.

Reliance on market discipline should not be confused with a policy of laissez-faire or benign neglect. To the contrary, as the PWG's principles spell out, market discipline often needs to be buttressed by government oversight. Notably, supervisors must diligently ensure that regulated firms--especially those core financial firms that act as creditors, counterparties, and clearing firms for highly leveraged entities, including hedge funds--adopt and implement best practices for monitoring and managing risks. These best practices could include those identified through cooperative private-sector initiatives, such as those of the Counterparty Risk Policy Management Group II. Importantly, best practices must address the challenges I mentioned earlier, including those relating to the complexity of instruments and strategies (which can make exposures difficult to measure), the illiquidity or potential illiquidity of positions held by the firm or its counterparties, and the risks of embedded as well as explicit leverage.

In implementing risk-focused and principles-based policies, we must also face the reality that finance does not stop at the water's edge. Financial globalization and financial innovation are closely tied, with each trend promoting the other. As a consequence, global regulatory coordination and collaboration are more vital than ever. We already work closely with our counterparts in the major industrial countries as well as in international forums such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). To the extent possible, we should work toward common principles and approaches as well as improved information sharing. International cooperation is also essential for establishing and maintaining effective oversight of the payment and settlement systems that constitute the infrastructure of global financial markets. Organizations such as the Committee on Payments and Settlements Systems

(CPSS) and IOSCO have developed shared international principles to ensure the safety and efficiency of payment systems.
Investor protection can also be addressed in a risk-focused, principles-based manner. Most important, disclosures and protections should be tailored to the level of sophistication of the investor. Mutual funds, for example, must provide disclosures sufficient to help retail investors make informed choices. When instruments and strategies are so complex that an unsophisticated investor could not be expected to effectively evaluate and manage the associated risks, U.S. regulators have chosen to limit the exposure of those investors. For example, most retail investors are effectively precluded from engaging in over-the-counter credit derivative transactions or from investing directly in hedge funds unless they meet various criteria regarding income and net worth.

Retail investors may have indirect exposures to complex instruments and strategies--for example, through pension funds. The appropriate principle for investor protection in this case is that the investors' agents--pension fund managers, for example--must apply sound risk-management practices and take risks consistent with the stated objectives of the ultimate investors. Regulators have a role to play in imposing fiduciary duties and standards on the investors' agents. For example, the Employee Retirement Income Security Act (ERISA) sets standards for private pension fund managers, including the requirements that, as fiduciaries, they act prudently and solely in the interest of the pension fund participants. Supervision of these fiduciaries must ensure that these standards are consistently met and that fiduciaries themselves fully understand the nature of their risk exposure.

Market integrity is the third public policy objective that I noted earlier. Consistent with a principles-based approach, U.S. securities laws against insider trading and market manipulation apply broadly to all financial institutions, including hedge funds, and to trading in a wide range of financial instruments, including securities-based over-the-counter derivatives transactions. Just as institutions and other investors need to adopt best practices to measure and manage risk, they should also have robust internal controls to ensure that the laws are not violated. For example, some market participants have expressed a concern that a bank may use nonpublic information in the credit derivatives market that it has obtained through its lending activities. To protect against such abuses, private-sector groups have proposed practices and principles for handling material nonpublic information--for example, by creating barriers between the staff members with access to such information and others. Risk-focused regulators and supervisors in turn should encourage effective implementation of these best practices, particularly in situations in which the potential for misuse, either intentional or unintentional, is high.

Conclusion

Financial innovation has great benefits for our economy. The goal of regulation should be to preserve those benefits while achieving important public policy objectives, including financial stability, investor protection, and market integrity. Although financial innovation promotes those objectives in some ways, for example by allowing better sharing of risks, certain aspects of financial innovation--including the complexity of financial instruments and trading strategies, the illiquidity or potential illiquidity of certain instruments, and explicit or embedded leverage--may pose significant risks. These risks should not be taken lightly.

Devising an appropriate regulatory response to financial innovation is challenging. I have argued today that we should strive to implement a regulatory regime that is principles-based, risk-focused, and consistently applied. Enhancing market discipline can complement and strengthen such an approach. As in the United Kingdom, a principles-based approach is not inconsistent with the use of rules, which can provide needed clarity or a safe haven from legal and regulatory risks. However, rules should implement principles rather than develop in an ad hoc manner. Admittedly, a fully consistent regulatory framework that focuses on the most significant threats to public policy objectives is an ideal that may never be fully realized, either here or abroad. However, determined efforts to work toward such a regime could provide substantial economic and social benefits.

EBSA: DOL Seeks Comments on Fee Disclosure for 401(k)-type Plans

Background
The U.S. Department of Labor's Employee Benefits Security Administration published in the April 25 edition of the *Federal Register* a "request for information" (RFI) to assist the department in improving information provided to an estimated 41 million participants about administrative and investment fees and expenses charged to 401(k)-type plans.
Fees and expenses can have a significant impact on workers' retirement savings. Thus, the Labor Department has undertaken three projects to improve fee disclosure to plan participants, enhance reporting of fees and expenses to the government, and increase disclosure to plan fiduciaries by service providers.

Information
The RFI requests comments on fee and expense disclosure issues affecting participants and beneficiaries of 401(k)-type plans governed by the Employee Retirement Income Security Act (ERISA). Specifically, the department seeks information concerning what administrative and investment-related fee and expense information participants should consider when investing their retirement savings, the manner in which the information should be furnished to participants and who should provide that information.

Reports by the 2004 ERISA Advisory Council and the General Accountability Office (GAO) provided suggestions for possible improvements in participant disclosure. In a recent report, GAO recommended both statutory and regulatory changes to improve disclosure of fees and expenses to plan fiduciaries and participants.

Summary
Written comments on the fee disclosure RFI should be submitted electronically by email to e-ori@dol.gov or through the federal e-rulemaking portal at www.regulations.gov. Paper-based comments should be sent to the Office of Regulations and Interpretations, Employee Benefits Security Administration, Room N-5669, U.S. Department of Labor, 200 Constitution Ave., N.W., Washington, D.C. 20210, Attention: Fee Disclosure RFI.

OCC: Soft Dollar Guidance

Background
On February 5, 2007 the Office of the Comptroller of the Currency provided guidance on soft dollar issues, specifically the use of commission payments by fiduciaries. This new guidance rescinds TBC-17, dated march 19, 1980, and TBC-25, dated June 19, 1986 which were based upon earlier SEC guidance. The Securities and Exchange Commission (SEC) issued on July 24, 2006, Release No. 34-54165, Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934 (2006 soft dollar guidance or release). Section 28(e) governs the conduct of all persons who exercise investment discretion with respect to an account, including investment advisers, mutual fund portfolio managers, fiduciaries of bank trust funds, and money managers of pension plans and hedge funds (money managers).

In the release, the SEC revised its previous interpretation of “brokerage and research services” as referred to in section 28(e). Section 28(e) provides a “safe harbor” to money managers, including bank fiduciaries, who use the commission dollars of their advised accounts to obtain brokerage and investment research services. Conduct outside of the safe harbor of section 28(e) may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities laws, particularly the Investment Advisors Act of 1940, and for certain accounts, the Employee Retirement Income Security Act of 1974 (ERISA).

Information
In the 2006 soft dollar guidance, the SEC articulates that the analysis of whether a money manager’s acquisition of brokerage and research services with client commissions falls within the section 28(e) safe harbor involves the money manager making a determination using a three-step analytical process. First, the money manager must determine whether the brokerage or research service falls within the specific statutory limits of section 28(e)(3). Second, the manager must

determine whether the eligible brokerage or research service provides lawful and appropriate assistance in the investment decision-making process. For "mixed-use" items that are partly eligible and partly ineligible, the release states that a money manager must make a reasonable allocation of client commissions in accordance with the eligible and ineligible uses of the items. Finally, money managers are expected to make a good faith determination that the amount of client commissions paid is reasonable in relation to the value of the brokerage and research services received. The release states that the prudent way for a money manager to meet its burden of showing eligibility for the safe harbor is to document fully its client commission-sharing arrangements.

Eligibility Criteria
The SEC release reiterates that money managers may use client commissions to pay only for eligible brokerage and research services. The release states that eligible research services are limited to *advice*, *analyses*, and *reports* under section 28(e). According to the release, when determining whether a product or service is eligible as "research" under section 28(e), the money manager must conclude that it reflects the expression of reasoning or knowledge and relates to the subject matter identified in section 28(e). The release also requires money managers to apply a "temporal" standard to distinguish between eligible and ineligible brokerage services. Under this standard, only brokerage services that relate to the execution of securities transactions and functions incidental thereto that occur between the time an order is transmitted to a broker-dealer and the time funds or securities are delivered or credited to the advised account are eligible for the safe harbor. The release also reiterates that when a product has a mixed use, a money manager must make a reasonable allocation of the cost of the product according to its use, and must keep adequate books and records concerning allocations. The release provides additional guidance and specific examples of eligible and ineligible research and brokerage products and services. Bank fiduciaries should consult the release for further information.

Third-party Research and Commission-sharing Arrangements
The release also addresses the eligibility criteria of third-party research and commission-sharing arrangements under section 28(e). The release states that the safe harbor is available when a money manager does business with a broker-dealer that is involved in "effecting" the money manager's trades and that also "provides" the research. According to the release, in order to be "effecting" transactions, the broker-dealer must either execute, clear, or settle the trade, or perform one of four specified functions detailed in the release and allocate the other functions to other broker-dealers. Under the release, the requirement that the broker-dealer "provide" the research is satisfied when the broker-dealer that is effecting transactions for the advised accounts is either legally obligated to pay for the research or pays the research preparer directly and takes steps to see that the services to be paid for with client commissions are within section 28(e).

Summary
The 2006 soft dollar guidance became effective on July 24, 2006. However, money managers, including bank fiduciaries, were able to rely on prior SEC guidance until January 24, 2007.

ICI: Comment Letter to the EBSA on the Interim Final Rule for Cross Trading Policies and Procedures

Background
On April 13, 2007 the Investment Company Institute (ICI) issued a comment letter outlining items to be addressed in the final rule. ICI commended guidance issued by the U.S. Department of Labor concerning cross-trading exemptions, but recommends clarifications and additional guidance regarding its application to ICI member firms. ICI commended the Department for issuing prompt interim guidance on the cross trading exemption, noting the rule will allow investment managers to extend their existing cross trading programs to ERISA plans that meet the requirements of the statutory exemption. ICI also supported the Department's decision to follow, in many respects, the conditions of Rule 17a-7 under the Investment Company Act of 1940 in regards to the requirements for an investment manager's policies and procedures on cross trading.

The ICI believes certain aspects of the interim final rule warrant clarification or additional guidance. First, they urge the Department to clarify that the exemption applies to cross trading between accounts managed by affiliated investment managers and to pooled funds where at least one participating plan has assets of at least $100 million. Second, they make several suggestions to streamline the required policies and procedures and enhance their compatibility with Rule 17a-7. They also request that the Department revise the interim rule to permit annual determinations on whether a plan meets the $100 million asset requirement. Finally, they recommend that the Department use its existing exemptive authority to go beyond the statutory exemption and permit plans of all sizes to enjoy the benefits of cross trading. Below is an excerpt from the ICI comment letter.

Information
I. The Department Should Clarify the Scope of the Exemption
We ask the Department to clarify that the exemption covers cross trades between affiliated managers and that the exemption is available to commingled funds that are subject to ERISA, where at least one participating plan satisfies the asset requirement.

<u>A. Cross Trading with Accounts of Affiliated Advisers</u>
The exemption in ERISA section 408(b)(19) covers transactions between a plan and any other account "managed by the same investment manager." Many cross trading programs cover trades between accounts of affiliated managers. For example, a financial institution may have one investment adviser subsidiary that manages mutual funds, another that manages separate account investments, and possibly also a trust company subsidiary that manages collective investment funds. To maximize the opportunities for clients to benefit from cross trading, the firm would want to consider all of its subsidiaries' managed accounts for this purpose.

There is no apparent reason for limiting the scope of the exemption to accounts of a single investment manager, as opposed to covering both that manager and its affiliates. Therefore, the Institute urges the Department to clarify that the term "same investment manager" as used in section 408(b)(19) covers both a single investment manager as well as affiliated investment managers, with "affiliate" defined to cover an entity controlling, controlled by, or under common control with the investment manager.

<u>B. Common or Collective Trusts</u>
Another way to improve the utility of the exemption would be to clarify that the exemption is available to a common or collective trust or other pooled investment vehicle where at least one participating plan has assets of at least $100 million. This interpretation should extend to master-feeder trust arrangements, where the only investors in the "master" collective trust (the entity that would engage in cross trades) are other collective trusts. So long as one of the participating "feeder" trusts includes a plan with $100 million, the entire master trust should be permitted to cross trade with the consent of a fiduciary of the $100 million plan. Otherwise, it is unclear whether a plan that by itself meets the asset requirement can take advantage of cross trading if it participates in a collective trust or master-feeder arrangement. It would serve no purpose to restrict the ability of common or collective trusts to cross trade. The other participating plans would benefit from cross trading within the collective fund. Furthermore, while acting to protect its own interests, the qualifying plan will protect the other participants in the fund.

II. The Department Should Clarify Certain Content Requirements
<u>A. Scope of Policies and Procedures Requirements</u>
We make two suggestions with respect to the scope of the policies and procedures as outlined in subsection (b)(3) of the interim final rule. First, subsection (b)(3)(i) requires that the manager's policies and procedures, among other things, "be fair and equitable to all accounts participating in its cross-trading program." The meaning of this standard is somewhat unclear, but the goal should be for accounts to be treated fairly and equitably in the resulting transactions. That is, the fairness and equity of the policies and procedures should be judged based not on their terms, but on the results they achieve in transactions carried out pursuant to those terms. Policies and procedures should be reasonably designed to achieve such results. To give more precise meaning to this standard, subsection (i) should be reworded as follows (strike-through text indicating deletions and italicized text indicating insertions):

(i) An investment manager's policies and procedures must be *reasonably designed (1) to ensure that transactions entered into pursuant to the policies and procedures are* fair

> and equitable to all accounts participating in its cross-trading program and (2) reasonably designed to ensure compliance with the requirements of section 408(b)(19)(H) of the Act *and the requirements of this regulation.*

Second, we ask the Department to clarify that non-compliance with the written policies and procedures required to be adopted under the interim final rule, in itself, would not mean that the exemption ceases to be available, either for a specific transaction or for all the cross trades of the particular manager. This interpretation is consistent with the statutory language requiring that the annual compliance report describe any specific instances of non-compliance with the manager's written policies and procedures (see section 408(b)(19)(I)). There is no indication that Congress intended that non-compliance with the policies and procedures, in itself, would cause the exemption not to be available for cross trades by a particular manager, so long as the non-compliance does not result in the failure to meet one of the conditions in subsections (A) through (G) of the statute. The statute contemplates, in subsection (I), a process by which an individual will monitor compliance with the policies and procedures, and will describe any specific instances of non-compliance in a report that is furnished to the authorizing plan fiduciary. The authorizing fiduciary can then determine, based on the information in the report, whether any action is warranted based on the described instance of non-compliance, including termination of the authorization.

B. Requirement to Describe How Manager Will Mitigate Conflicts

Under the interim final rule, policies and procedures are required to contain:

(D) A description of how the investment manager will mitigate any potentially conflicting division of loyalties and responsibilities to the parties involved in any cross-trade transaction.

We believe this requirement is unnecessary because conflicts of interest are adequately addressed by other provisions in the regulation. All the other required elements under the policies and procedures are designed to serve this same purpose. The principal protections for accounts participating in the cross trading program are the requirements that (1) the transaction be beneficial to both parties to the cross trade; (2) the cross trade be effected at the independent current market price of the security; and (3) the cross trading opportunities be allocated in an objective and equitable manner. These enumerated protections address any potentially conflicting loyalties and responsibilities, by assuring that the underlying transaction is beneficial to both parties and that the trade is effected in a fair and equitable manner. Since the requirement in subparagraph (D) overlaps with other conditions in the exemption and interim final rule and does not provide any additional protection, it should be deleted to avoid confusion.

C. Role of Compliance Officer

The interim final rule describes the role of the compliance officer as being to determine whether the manager's cross trading program complies with the policies and procedures required by section 408(b)(19)(H), without describing the specific steps that the compliance officer should take. We support this approach because it allows an investment manager to integrate policies and procedures on cross trading for ERISA accounts with its over-all compliance policies and procedures.

In this regard, we request that the Department clarify that the compliance officer of an SEC-registered investment adviser may operate in a manner consistent with the SEC rules regarding the role of a chief compliance officer under the Investment Advisers Act of 1940 and the Investment Company Act of 1940. These rules permit a chief compliance officer to rely on others (including independent third parties such as an independent certified public accounting firm) to carry out the review of the adequacy and effectiveness of implementation of policies and procedures, and do not require the review to cover every transaction. The compliance review under section 408(b)(19)(I) should be under the oversight of the designated compliance officer but it should be possible for the compliance officer to delegate responsibility for specific segments of the review. The compliance officer also should be able to focus on the overall adequacy and effectiveness of the implementation of the policies and procedures, including reviewing a sampling of transactions rather than reviewing each individual transaction. This would be consistent with the statutory requirement, which describes the role of the designated compliance officer as "periodically reviewing" the purchases and sales effected under the procedures.

D. Verification of $100 Million Asset Requirement

Section 408(b)(19)(E) of ERISA requires that any plan (or master trust containing the assets of plans maintained by employers in the same controlled group) participating in a cross trade transaction have assets of at least $100 million. Subsection (b)(3)(i)(C) of the interim rule states that a plan or master trust will meet the minimum asset size requirement if it meets the requirement upon its initial participation in the cross trading program and on a quarterly basis thereafter. While it is helpful that the interim rule provides guidance on how frequently a manager must monitor plan size, we believe annual verification would be more suitable. Many managers only obtain updated information regarding their customers on an annual basis. It is not uncommon for an investment manager to manage only a portion of a plan's assets, in which case, the manager would not have continuous access to information on the client plan's overall asset level. Therefore, we urge the Department to permit annual verification of a plan's satisfaction of the asset requirement.

III. The Department Should Provide Administrative Exemptive Relief for Smaller Plans
Although the exemption for cross trading enacted by Congress is long overdue, the statutory exemption is too limited in one critical respect. In addition to the disclosure, consent, pricing, and reporting provisions, the PPA exemption is limited to plans with assets of at least $100 million - a standard met by only 3.9 percent of defined benefit plans. In the Institute's view, this "belt and suspenders" approach is not necessary to protect plans and their participants and denies the benefits of cross trading to far too many plans. The disclosure, consent, pricing, compliance and reporting provisions of the PPA exemption are robust and the Department should rely on these conditions to fashion an administrative prohibitive transaction exemption for plans with assets below $100 million.

Investment managers enter into cross trades to benefit clients. Cross trading can reduce transaction costs for clients, implement orders more efficiently, and minimize the market impact of large orders. In a cross trade, the client avoids various charges and fees associated with purchasing or selling a security on the market. Both sides of a cross trade save on commissions or benefit from lower bid/ask spreads. These cost-savings are recognized in the mutual fund industry, where mutual funds have been able to engage in cross trades since 1966. Reduced transaction costs will result in more money actually being invested (and generating earnings) for plans and their participants.

Cross trading also eliminates duplicative efforts (e.g., selling securities piecemeal for one account while simultaneously buying similar securities for another account) and results in faster implementation of orders. Moreover, when a plan's trade involves a large amount of securities, an open market purchase or sale can disproportionately affect the market price of the security to the disadvantage of the plan. A large buy or sell order, by itself, can move the price of a security. Cross trades have little or no market impact and result in a fair price for both sides of the transaction, under the independent pricing requirement.

Plans below the $100 million limit may have less bargaining power to obtain lower commissions from brokers and potentially could benefit more from cross trading relative to larger plans. Particularly with respect to fixed income securities, smaller trades can be less efficient and have larger bid/ask spreads. Cross trading in these circumstances allows managers to achieve much lower spreads and best execution for their clients.

Summary
The ICI states the under section 408(a) of ERISA, the Department has clear authority to grant class exemptions from the prohibited transaction restrictions imposed by section 406. They urge the Department to exercise this authority to provide cross trading relief for plans with assets of less than $100 million.

ABA: Senate Testimony Regarding Sarbanes-Oxley Concerns

Background
The American Bankers Association raised concerns to Congress on April 18, 2007 regarding the huge time and cost burdens associated with the Sarbanes-Oxley Act, particularly Section 404, which requires an annual evaluation and verification of the adequacy of internal controls by auditors.

Information - Testimony

In testimony before the Senate Committee on Small Business and Entrepreneurship, Thomas Venables, CEO of Benjamin Franklin Bank, Franklin, Mass., explained that his own institution, which has $913 million in assets and 186 employees, incurred costs of approximately $420,000 – and over 2,200 man-hours – during 2006 to comply with Section 404.

"This represents 6 percent of our normalized earnings," said Venables. "It is hard enough to be struggling with an inverted yield curve and tremendous loan and deposit competition in our markets, but to start off the earnings year at 94 percent of potential because Section 404 compliance costs – well, this is difficult."

Venables urged that the revised rules proposed by the SEC and Public Company Accounting Oversight Board be finalized quickly and should include a delayed implementation date for non-accelerated filers (those under $75 million in market capitalization).

He also requested that another set of rules, those related to shareholder threshold for SEC registration, should be updated.

"The shareholder level has remained at the same level since it was first set in 1964," said Venables. "The ABA strongly recommends updating the Exchange Act registration shareholder threshold to between 1,500 and 3,000 record shareholders. The threshold for deregistration should also be brought in line to between 900 and 1,800 record shareholders."

Implementation of the rules should focus on cost reductions, but can only be realized if the auditing firms apply them as intended by the rule-makers, he explained.

"The SEC and PCAOB have achieved the proper balance with their proposals, but monitoring the results will be extremely important to determining the success of the changes," said Venables.

Venables expressed concern that non-accelerated filers should be given adequate advance notice of required compliance – a minimum of one full year in the case of calendar year companies – to allow for successful implementation and testing.

"We are concerned that during the recent Section 404 meeting of the SEC there was no mention of a specific delay of the compliance for non-accelerated filers. It is urgent that the SEC provide relief to these small businesses in a timely fashion," said Venables.

He explained that non-accelerated filers are required to produce reports this year on internal controls, and that in order to comply, they must decide now whether to follow the old rules or follow the recently proposed rules.

"Placing such a significant time constraint on these smaller companies is unreasonable," said Venables.