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Introductory Comment: I am certain we all felt a sense of pride watching the athletes perform at the 2008 Summer Olympics. Just like the Olympic athletes, you too must be on the top of your game and continue to train to achieve the "gold" within your profession. Outlined below are various items I believe to be important as you continue to train and improve the performance of your organization and the industry. The first two items are related and focus upon the importance of understanding the use of soft dollars. I have also included a discussion regarding the proposed disclosure requirements and prospectus delivery for open-end mutual funds. Keeping with the disclosure theme, I have included the Employee Benefits Security Administration's proposal for the fiduciary disclosure requirements in directed plans. And wrapping up this edition I have outlined the Agencies Supervisory Guidance specific to Pillar 2 of the Basel requirements.

SEC – Speech by Chairman Cox; Statement at Open Meeting on Guidance to Fund Boards Regarding Investment Adviser Trading of Fund Portfolio Securities and Use of Soft Dollars

Background

On July 30, SEC Chairman Christopher Cox provided a statement at the Open Meeting on the topic of Guidance to Fund Boards regarding Adviser Trading of Fund Portfolio Securities and the use of soft dollars. This information is useful and provides insight into the Commission's thoughts on these areas.

Comments

Our next item of business is a Commission release that would propose guidance to mutual fund boards on managing their investment advisers' conflicts of interests in trading activities, particularly the use of soft dollars. The proposed guidance is intended to help directors analyze when it's necessary or advisable to rein in the adviser's use of soft dollars. This is an important subject for the millions of retail investors in mutual funds in particular, because soft dollars are their dollars.

Today, over 40 percent of American households entrust their savings and retirement assets to mutual funds and other investment companies. The protection of these investments, therefore, is of vital importance for all of them. Mutual funds and other investment companies typically are operated by investment advisers and other organizations that are separate from the funds themselves. This external management can lead to conflicts of interest between the fund and its investment adviser. Conflicts of interest, of course, are a fact of life in our complex economy, but they can also present opportunities for abuse.

Congress recognized the potential for abuse stemming from fund advisers' conflicts of interest, and it assigned the policing of these conflicts to the funds' boards of directors. The Investment Company Act, and the fiduciary responsibilities of directors under state law, place important duties on the shoulders of fund directors to oversee the safety of fund assets and the protection of investors.

One of the most significant conflicts of interest arises when a fund's investment adviser directs the trading of a fund's portfolio, and especially when the adviser uses soft dollars as part of its business practices. Soft dollars are essentially credits earned from brokerage commissions that a broker-dealer's customer can use to pay the broker dealer for research reports or other things of value. These soft dollars total almost one billion dollars a year. They represent the assets of investors, although investors themselves neither monitor nor approve the accumulation and spending of these assets. Therefore, it is critical that fund directors understand how a fund adviser uses soft dollars, and whether soft dollars are being spent in the best interest of fund investors who ultimately pay for them.

Over the years, the Commission has taken action to address the conflicts in connection with an adviser's trading activities on behalf of funds. We have clarified the adviser's obligation to act in the fund's best interest by seeking best execution on fund portfolio trades. We have also acted numerous times to address the conflicts raised by soft dollars. Most recently, in 2006 we issued interpretive guidance to clarify for advisers and other money managers what they can and cannot purchase with soft dollars under the safe harbor provided to them in Section 28(e) of the Exchange Act.

The guidance that we are proposing today for fund directors follows naturally from the guidance we provided for fund advisers in 2006. Directors fulfill their obligation to protect fund investors through the oversight of the adviser's trading practices to ensure the adviser is acting in the fund's best interest. But in today's rapidly changing markets, boards are presented with new and difficult challenges in fulfilling that oversight role. With the increasing use of alternative trading venues, such as dark pools, and the use of algorithmic trading and client commission arrangements, evaluating an adviser's trading practices can sometimes seem an overwhelming task.

From a fund director's perspective, the technological developments in the brokerage industry have created something of a double-edged sword. On the one hand, electronic trading allows greater transparency because funds are able to determine more easily the precise costs of execution and research. On the other hand, with this information readily available, our staff has been told that directors are routinely given reams of trade data that they simply do not have the time or the expertise to digest.

The guidance we are considering today is intended to assist fund directors in fulfilling their responsibilities by providing them a flexible framework when evaluating an adviser's trading practices. Our goal is to help directors focus their review efforts and evaluate an adviser's trading activities in the most efficient and effective way possible.
In fulfilling their oversight role, fund directors also must be informed of the scope and nature of their duties and responsibilities. In particular, they must understand that they have the authority to demand information from their fund's investment adviser and that the adviser has to provide that information. When directors evaluate an adviser's trading practices, they may decide not to approve the adviser's use of fund assets, in which case the board can direct the adviser to conduct

its trading practices as the directors believe is appropriate. For example, a fund board may limit an adviser's use of soft dollars, or possibly prohibit an adviser from using soft dollars altogether, even for items that may otherwise fall within the safe harbor provided by Section 28(e) of the Exchange Act.

The conflicts and the costs to investors associated with advisers' trading practices are very serious. Fund boards are in the best position to monitor and evaluate the management of any potential conflicts of interest that may harm the interests of the fund and its shareholders. So I look forward to the comments the Commission may receive on our proposed guidance to assist fund boards in fulfilling these very important responsibilities.

SEC – Commission Guidance Regarding the Duties and Responsibilities of Investment Company Boards of Directors with Respect to Investment Adviser Portfolio Trading Practices

Background

On July 30, 2008 the Securities and Exchange Commission ("Commission") published for comment proposed guidance to boards of directors of registered investment companies to assist them in fulfilling their fiduciary responsibilities with respect to overseeing the trading of investment company portfolio securities. The guidance focuses on the role of an investment company board in overseeing the best execution obligations of the investment adviser hired to invest in securities and other instruments on the investment company's behalf. In this respect, the Commission addresses the conflicts of interest that may exist when an investment adviser uses an investment company's brokerage commissions to purchase services other than execution, such as the purchase of brokerage and research services through client commission arrangements. The Commission also is requesting comment on whether to propose that advisers be subject to new disclosure requirements concerning the use of client commission arrangements to investment company shareholders and other investment advisory clients. Comments should be received on or before October 1, 2008.

Introduction

Many investment advisers, in connection with trades placed on behalf of their registered investment company, or "fund," clients, receive brokerage and research services in reliance on the safe harbor provided under section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act"). In recent years, changes in client commission practices, evolving technologies, and marketplace developments have transformed the brokerage and investment management industries and securities trading practices. In recognition of changing market conditions and current industry practices, in July 2006, the Commission issued an interpretive release that provided guidance to investment advisers with respect to, among other things, the scope of the safe harbor provided under section 28(e) when advisers use brokerage commissions to purchase brokerage and research services for their managed accounts. In addition to providing guidance to investment advisers on their use of soft dollars, the Commission believes it is important to provide guidance to fund boards of directors concerning their responsibilities to oversee the adviser's satisfaction of its best execution obligations, including the adviser's use of fund brokerage commissions and the overall transaction costs that the fund incurs when the fund buys or sells portfolio securities. As the Commission has stated previously, transaction costs are a concern for fund investors for two reasons. First, for many funds, the amount of transaction costs incurred may be substantial. Second, fund advisers are subject to a number of potential conflicts of interest in conducting portfolio transactions on behalf of clients that are funds. Fund brokerage commissions, which are paid out of fund assets, may, for example, be used to obtain brokerage and research services under section 28(e) of the Exchange Act that might otherwise be paid for directly by the fund's investment adviser.

The Commission recognizes that conflicts of interest are inherent when an investment adviser manages money on behalf of multiple clients. As discussed in Section II of this Release, conflicts are also inherent in the external management structure of funds. Investment advisers are required to disclose material conflicts of interest to their clients, and those conflicts should be managed appropriately. Fund directors play a pivotal role in overseeing conflicts of interest investment advisers face when they have funds as clients.

As explained in further detail in Section III of this Release, fund transaction costs may not be readily apparent to investors. It is imperative that the fund's directors both understand and scrutinize the payment of transaction costs by the fundand determine that payment of transaction costs is in the best interests of the fund and the fund's Shareholders. Although directors are not required or expected to monitor each trade, they should monitor the adviser's trading practices and the manner in which the adviser fulfills its obligation to seek best execution when trading fund portfolio securities. In doing so, the fund's board should demand, and the fund's adviser must provide, all information needed by the fund's board to complete this review process. Without sufficient oversight by the fund's board, transaction costs might inappropriately include payment for services that benefit the fund's adviser at the expense of the fund and that the board believes should be paid directly by the adviser rather than with fund assets.

The Commission has received requests from fund directors for guidance on the Commission's view of their responsibilities in overseeing the activities of the investment advisers that trade their funds' portfolio securities. These requests include inquiries as to how directors may properly fulfill their responsibilities with respect to overseeing an adviser's satisfaction of its best execution obligations, including the adviser's trade execution practices and the adviser's use of fund brokerage commissions. Today the Commission is proposing guidance with respect to information a fund board should request that an investment adviser provide to enable fund directors to determine that the adviser is fulfilling its fiduciary obligations to the fund and using the fund's assets in the best interest of the fund. The proposed guidance also is intended to assist the board in directing the adviser as to how fund assets should be used.

The proposed guidance would not impose any new or additional requirements. Rather, it is intended to assist fund directors in approaching and fulfilling their responsibilities of overseeing and monitoring the fund adviser's satisfaction of its best execution obligations and the conflicts of interest that may exist when advisers trade the securities of their clients that are funds. In developing this proposed guidance, the Commission has taken into account the wide variety of funds and advisers in terms of size, asset classes, complexity, and operations. The Commission has also considered the changing market environment in the brokerage and investment management industries. The Commission feels that with rapidly evolving market conditions and trading practices, it is appropriate to give guidance at this time. For these reasons, the Commission is proposing guidance for fund directors to consider in performing their responsibilities and in determining what is appropriate in light of their fund's particular circumstances.

The intention in this proposed guidance is to assist boards. The Commission wishes to provide guidance that is relevant, useful, and beneficial to fund directors in fulfilling their responsibilities to act in the best interest of investors in this area. The Commission requests comment on all aspects of the proposed guidance to help us in achieving this goal. In addition, as the evolving nature of brokerage practices greatly influences how directors approach their oversight responsibilities in this area, the Commission specifically requests comment on the current state of the brokerage and investment management industries and its effect on advisers' trading of fund portfolio securities.

Law Regarding Fiduciary Responsibilities of Investment Company Directors
In fulfilling their responsibilities to a fund that they oversee, fund directors should understand the nature and source of their legal obligations to the fund and the fund's shareholders. Because funds are generally formed as corporations, business trusts, or partnershipsunder state law, fund directors and trustees, like other corporate directors, are subject to a "duty of care" and a "duty of loyalty" under state and common law, fiduciary principles, as well as the obligations imposed on them under the Investment Company Act.

A director's duty of care generally requires a fund director to perform his or her oversight responsibilities with the care of an ordinarily prudent person in a like position under similar circumstances. The duty of care thus establishes the degree of attention and consideration required of a director in matters related to the fund he or she oversees. As such, a director's duty of care incorporates a duty to be informed, requiring that a director be reasonably informed about an issue before making a decision relating to that issue. To be reasonably informed about an issue, a director must inform him or herself of all material information regarding that issue reasonably available to him or her. In fulfilling these obligations, a fund director may rely on written and oral reports provided by management, auditors, fund counsel, the fund's chief compliance officer ("CCO"), and other experts and committees of the board when making decisions, so long as the director reasonably believes that the reports are reliable and competent with respect to the relevant matters.

A director's duty of loyalty requires him or her to act in the best interests of the fund and the fund's shareholders. The duty of loyalty encompasses a director's obligations to avoid conflicts of interest with the fund and the fund's shareholders, not to put his or her personal interests before the interests of the fund and the fund's shareholders, and not to profit from his or her position as a fiduciary.

In addition to statutory and common law obligations, fund directors are also subject to specific fiduciary obligations relating to the special nature of funds under the Investment Company Act.[25] Unlike typical operating companies, funds ordinarily do not have any employees that are truly their own, but rather are generally formed and managed by a separately owned and operated sponsor, commonly an investment adviser.

This external management structure of most funds may at times create conflicts of interest for investment advisers with clients that are funds. When it enacted the Investment Company Act, Congress recognized the potential for abuse created by the unique structure of funds. To protect fund shareholders, the Act requires that each registered fund be governed by a board of directors with the authority to supervise the fund's operations. The Act further requires that at least 40 percent of a fund's board be independent in order to serve as "independent watchdogs" in monitoring the fund's managing organization. A fund board has the responsibility, among other duties, to monitor the conflicts of interest facing the fund's investment adviser and determine how the conflicts should be managed to help ensure that the fund is being operated in the best interest of the fund's shareholders.

Board Oversight of Investment Adviser Trading Practices
In overseeing the use of fund assets and in monitoring the conflicts of interest faced by a fund's investment adviser, a fund board must consider the investment adviser's practices when it trades the fund's portfolio securities. A fund's investment adviser is a fiduciary with respect to the fund and therefore must act in the fund's best interest. Lower transaction costs generally are in

the mutual interest of a fund's adviser and the fund's investors, and advisers typically seek to minimize transaction costs when trading fund securities so as not to detract from the fund's performance. At times, however, there may be incentives for an investment adviser to compromise its fiduciary obligations to the fund in its trading activities in order to obtain certain benefits that serve its own interests or the interests of other clients. These conflicts of interest may exist, for example, when an adviser executes trades through an affiliate, when it determines the allocation of trades among its clients, and when it trades securities between clients. In addition, the use of fund brokerage commissions to pay for research and brokerage services may give incentives for advisers to disregard their best execution obligations when directing orders to obtain brokerage commission services. It also may give incentives for advisers to trade the fund's securities in order to earn credits for fund brokerage commission services. In accordance with its fiduciary obligations and provisions of the Advisers Act, an adviser must make full and fair disclosure of these conflicts to a client and disclose how the adviser will manage each conflict before the adviser may engage in conduct that constitutes a conflict.

The fund's board, in providing its consent on the fund's behalf, should be sufficiently familiar with the adviser's trading practices to satisfy itself that the adviser is fulfilling its fiduciary obligations and is acting in the best interest of the fund. In some cases where the Commission has adopted exemptive rules that permit funds to engage in transactions otherwise prohibited by the Investment Company Act, the Commission has imposed conditions designed to address certain conflicts of interest faced by advisers by mandating that directors take particular action in evaluating those conflicts. In other cases, the Commission has determined that the conflicts relating to a particular practice are unmanageable and has therefore prohibited advisers' activities in that area altogether.

Two specific areas where conflicts may arise when an adviser trades a fund's portfolio securities concern the adviser's obligation to seek best execution and to otherwise use fund assets, including brokerage commissions, in the best interest of the fund. The following sections provide guidance on the types of information a fund board should seek in order to evaluate whether the adviser to its fund has fulfilled its obligations to the fund with respect to these concerns.

<u>Board Oversight of an Investment Adviser's Duty to Seek Best Execution and Consideration of Transaction Costs</u>

As a fiduciary to a client that is a fund, an investment adviser has the duty to seek best execution of securities transactions it conducts on the fund's behalf. As has been stated previously, in seeking best execution, an investment adviser must seek to "execute securities transactions for clients in such a manner that the client's total cost or proceeds
Act rule 17e-1(b) [17 CFR 270.17e-1(b)] in each transaction is the most favorable under the circumstances." In this regard, in seeking to maintain best execution on behalf of a client that is a fund, an adviser should consider factors beyond simply commission rates or spreads, including "the full range and quality of a broker's services in placing brokerage. These might include, among other things, the value of research provided, execution capability, financial responsibility, and responsiveness to the adviser.

When trading portfolio securities of a client that is a fund, an adviser should consider factors related to minimizing the overall transaction costs incurred by the fund. Transaction costs consist of explicit costs that can be measured directly, such as brokerage commissions, fees paid to exchanges, and taxes paid, as well as implicit costs that are more difficult to quantify. Implicit costs, which may include, among other things, bid/ask spreads, the price impact of placing an order for trading in a security, and missed trade opportunity cost, may exceed greatly a transaction's explicit costs. Price impact and opportunity cost can be influenced by a variety of factors – each of which should be considered by an investment adviser – such as the anonymity of the parties to the trade, the willingness of the intermediary to commit capital to facilitate the trade, and the speed and price of the execution. Investment advisers also can take into account the quality and utility of any research provided by the broker-dealer.

An aspect of an adviser's best execution process that directors should also consider is the adviser's decision whether to use an alternative trading system. Newer trading venues, such as "dark pools," and the use of advanced mathematical models or algorithmic trading systems, crossing networks, and other alternative trading systems, are increasingly prevalent. Although the use of such trading venues may provide funds certain benefits (such as potentially lower execution costs), they can also raise challenges to funds in certain situations.

Fund directors should seek relevant data from the fund's investment adviser to assist them in evaluating the adviser's procedures regarding its best execution obligations. This data should typically include, but not be limited to: (i) the identification of broker-dealers to which the adviser has allocated fund trading and brokerage; (ii) the commission rates or spreads paid; (iii) the total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period; and (iv) the fund's portfolio turnover rates. Fund boards may also discuss related matters with the adviser, which may include the following, where applicable:

- The process for making trading decisions and the factors involved in the selection of execution venues and the selection of broker-dealers;
- The means by which the investment adviser determines best execution and evaluates execution quality as well as how best execution is affected by the use of alternative trading systems;
- Who negotiates commission rates, how that negotiation is carried out, whether the amount of commissions agreed to depends on comparative data with respect to commission rates, and generally how transactions costs are measured;
- How the quality of "execution-only" trades – trades that do not include payment for any additional research or services beyond execution – is evaluated compared to that of other trades (for example, whether trades that are executed through channels that include an additional soft dollar component are reviewed in comparison with execution-only trades to discern any discrepancies in the quality of execution);
- How the performance of the adviser's traders is evaluated, as well as the aggregate performance of the firm's traders as a whole, how the performance of each broker-dealer the adviser uses for fund portfolio transactions is evaluated, and how problems or concerns that are identified with a trader or a broker-dealer are addressed;
- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser's activities, including the trading intermediary selection process;
- To what extent and under what conditions the adviser conducts portfolio transactions with affiliates;
- The process for trading fixed-income securities and determining the costs of fixed income transactions;
- How the quality of trade execution is evaluated with respect to fixed-income and other instruments traded on a principal basis; and
- If there are international trading activities, how these trades are conducted and monitored.

The Commission acknowledges that not all funds would require an evaluation of each of these factors by their boards. Different factors may be appropriate for different funds, depending on a fund's investment objective, trading practices, and personnel.

Board Oversight of an Investment Adviser's Use of Fund Brokerage Commissions

When trading portfolio securities on behalf of clients that are funds, there are a number of ways in which an investment adviser may use a portion of fund brokerage commissions to benefit the fund beyond execution of the securities transaction. First, a fund adviser may use a portion of fund brokerage commissions to purchase research and/or research-related services in accordance with section 28(e) of the Exchange Act. The research may be "proprietary" research, produced by the broker-dealer executing the securities transaction or its affiliates, or it may be "third-party research," produced or provided by someone other than the executing broker-dealer. Investment advisers also may purchase third-party research themselves using cash payments from their own account, or "hard dollars." Furthermore, investment advisers may obtain proprietary and third-party research through a "client commission arrangement." In a client commission arrangement, an investment adviser agrees with a broker-dealer effecting trades for the adviser's client accounts that a portion of the commissions paid by the accounts will be credited to purchase research either from the executing broker or another broker, as directed by the adviser.

In addition to obtaining research and research-related services with fund brokerage commissions, an adviser may use fund brokerage commissions in other ways.
For example, an adviser may utilize a commission recapture arrangement, whereby the fund receives a portion, or rebate, of the brokerage commission (or spread) charged by the broker-dealer handling the trade. Additionally, an investment adviser may use fund brokerage to pay certain providers for services utilized by the fund through an expense reimbursement arrangement with a broker-dealer and/or its affiliates.

Because fund brokerage commissions are fund assets, investment advisers have a conflict of interest when they use commissions to obtain research and related services that they would otherwise have to pay for themselves. Advisers therefore are subject to certain requirements when using fund brokerage in this manner. First, section 17(e)(1) of the Investment Company Act prohibits investment advisers to registered investment companies from using soft dollars to obtain research or services outside the confines of the safe harbor provided by section 28(e) of the Exchange Act. Second, investment advisers, as fiduciaries, generally are prohibited from receiving any benefit from the use of fund assets,[64] although an investment adviser's use of soft dollars creates opportunities for the adviser to benefit in ways that may not be in the best interest of the fund. These conflicts of interest arise in a number of ways when investment advisers use fund assets in soft dollar programs. For example:

- The use of fund brokerage commissions to buy research may relieve an adviser of having to produce the research itself or having to pay for the research with "hard dollars" from its own resources;
- The use of soft dollars may give an adviser an incentive to compromise its fiduciary obligations and to trade the fund's portfolio in order to earn soft dollar credits;
- The availability of soft dollar benefits that an adviser may receive from fund brokerage commissions creates an incentive for an adviser to use broker-dealers on the basis of their research services provided to the adviser rather than the quality of execution provided in connection with fund transactions;

- An adviser may seek to use fund brokerage commissions to obtain research that benefits the adviser's other clients, including clients that do not generate brokerage commissions (such as fixed-income funds), those that are not otherwise paying more than the lowest available commission rate in exchange for soft dollar products or services (i.e., "paying up" in commission costs), or those from which the adviser receives the greatest amount of compensation for its advisory services;
- The use of soft dollars may disguise an adviser's true costs and enable an adviser to charge advisory fees that do not fully reflect the costs for providing the portfolio management services;
- The use of fund brokerage commissions to obtain research and other services may cause an adviser to avoid other uses of fund brokerage commissions that may be in the fund's best interest, such as establishing a commission recapture program or fund expense reimbursement arrangement to offset expenses that are paid for with fund assets; and
- In the case of "mixed-use" products – for example, research products or services obtained using soft dollars that may serve functions that are not related to the investment decision-making process, such as accounting or marketing – an adviser has a conflict when making an allocation determination between the research and non-research uses of the product as required to fulfill the requirements under section 28(e) of the Exchange Act.

When evaluating an adviser's use of fund brokerage commissions in light of these conflicts, a fund board may determine that such use is in the best interests of the fund.

Section 28(e) under the Securities Exchange Act of 1934

Section 28(e) of the Exchange Act provides a safe harbor that protects investment advisers from liability for a breach of fiduciary duty solely on the basis that the adviser caused an account over which it exercises investment discretion to pay more than the lowest commission rate in order to receive brokerage and research services provided by a broker-dealer, if the adviser determined in good faith that the amount of the commission was reasonable in relation to the value of the brokerage and research services received. As the Commission has stated, section 17(e)(1) of the Investment Company Act, prohibits investment advisers to registered investment companies from obtaining brokerage and research services with fund brokerage commissions outside the section 28(e) safe harbor.

The 2006 Release provides guidance with respect to the appropriate framework for analyzing whether a particular service falls within the "brokerage and research

the safe harbor itself recognizes that the parties to an investment management relationship may by contract opt *out* of Section 28(e)."). A fund board should request that the fund adviser inform directors of the policies and procedures the adviser uses to ensure that the types of brokerage and research services the adviser obtains using fund brokerage commissions fall within the safe harbor and that the adviser has not engaged in excessive trading in light of the fund's investment objectives. In turn, in approving the policies and procedures, a board should consider whether they are reasonably designed to ensure that the adviser's use of fund brokerage commissions complies with the section 28(e) safe harbor, as well as all the federal securities laws.

In addition, as was stated in the 2006 Release, to rely on the section 28(e) safe harbor, an adviser must: (i) determine whether the product or service obtained is eligible research or brokerage under section 28(e); (ii) determine whether the eligible product actually provides lawful and appropriate assistance in the performance of his investment decision-making responsibilities; and (iii) make a good faith determination that the amount of client commissions paid is reasonable in light of the value of products or services provided by the broker-dealer. The Commission also reaffirmed an investment adviser's essential obligation under section 28(e) to make this good faith determination and that the burden in demonstrating this determination rests on the investment adviser. An adviser should demonstrate to the board that it has met this burden.

<u>An Investment Adviser's General Fiduciary Obligations to Clients that Are Funds When Using Soft Dollars</u>

As has been stated, although a fund adviser may satisfy the requirements for using client commissions to pay for brokerage and research services under the section 28(e) safe harbor, a fund's directors still should evaluate the adviser's use of fund brokerage commissions to purchase research and services in order to determine whether the adviser is acting in the best interest of the fund. If a fund board determines that the adviser's use of brokerage commissions is not in the best interest of the fund, the board should prohibit or limit the use of fund brokerage commissions and direct the adviser accordingly.

In this regard, directors need to understand the procedures that the fund's investment adviser employs to address any potential conflicts of interest and ensure that fund commissions are being used appropriately. For example, to try to address concerns that a broker-dealer may be chosen by an adviser for reasons other than the quality of the broker-dealer's execution (including the brokerage and research services it provides), some advisers, particularly larger ones, may use an internal process referred to as a "broker vote" or "broker tolls," whereby the adviser's investment professionals, typically the portfolio managers and investment analysts, assess the value of the research and services different broker-dealers provide to determine which broker-dealer's research and other services the adviser should purchase.

To assist the board in understanding the adviser's policies and procedures regarding the use of fund brokerage commissions to obtain brokerage and research services, the board should request that the adviser inform the directors as to such matters as the following:

- How does the adviser determine the total amount of research to be obtained and how will the research actually be obtained?
- How does the adviser determine the amount to be spent using hard versus soft dollars?
- How does the adviser determine amounts to be spent on proprietary versus third-party research arrangements?
- What types of research products and services will the adviser seek to obtain and how will this research be beneficial to the fund?
- How does the adviser determine amounts to be used in commission recapture programs and expense reimbursement programs?
- What is the process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program? Is a broker vote process or some other mechanism used?
- Do any alternative trading venues that are used produce soft dollar credits? If so, how much?
- How does the adviser determine that the use of soft dollars is within the section 28(e) safe harbor? In particular:
- Is the product or service obtained eligible brokerage or research, as defined under section 28(e)?

- Does the product or service provide lawful and appropriate assistance to the adviser in carrying out its investment decision-making responsibilities?
- Is the amount of commissions paid reasonable (based upon a good faith determination) in light of the value of brokerage and research services provided by the broker-dealer?
- How does soft dollar usage compare to the adviser's total commission budget?
- How are soft dollar products and services allocated among the adviser's clients? Are the commissions paid for certain trades in fund portfolio securities similar to commissions paid for transactions in similar securities, or of similar sizes, by the fund and the adviser's other clients (including clients that are not funds)? Are other clients paying lower commissions that do not include a soft dollar component? If so, does the adviser adequately explain the discrepancy in commission rates and provide the board data sufficient to satisfy the board that the fund is not subsidizing the research needs of the adviser's other client? To what extent are the products and services purchased through soft dollar arrangements used for the benefit of fixed-income or other funds that generally do not pay brokerage commissions?
- What is the process for assessing the value of the products or services purchased with soft dollars?
- What is the process used to evaluate the portion of a mixed use product or service that can be paid for under section 28(e)?
- To what extent does the adviser use client commission arrangements? What effect do these arrangements have on how the adviser selects a broker-dealer to complete a particular transaction? How does the adviser explain that the use of client commission arrangements benefits the fund?[79]

As with the adviser's trading practices, after receiving appropriate input and information from the adviser, if the board believes that the fund's brokerage commissions could be used differently so as to provide greater benefits to the fund, the board should direct the adviser accordingly. For example, the adviser should explain to the board that the value the fund receives from the brokerage and research services purchased with fund brokerage commissions is appropriate, and whether the services are inappropriately benefiting another of the adviser's clients at the fund's expense. In directing the adviser, the board also should consider such matters as: (i) whether it is appropriate for the adviser to refrain from purchasing research services in connection with certain types of trades, depending on market conditions; (ii) whether it is appropriate for the adviser to use fund brokerage commissions to receive brokerage and research services on some or all trades; (iii) whether fund brokerage commissions should be used only in connection with a commission recapture or expense reimbursement program; and (iv) whether some combination of these alternatives may be in the best interest of the fund.

In addition, fund boards should inquire as to how the adviser's compliance policies and procedures with respect to soft dollars are determined and monitored. In deciding whether to approve these policies and procedures, directors should consider, and the investment adviser should explain, how the policies and procedures eliminate or otherwise mitigate the conflicts of interest that exist when an adviser trades portfolio securities on the fund's behalf. Furthermore, the value of research obtained through the use of soft dollars is a factor a fund board should consider when determining whether an investment adviser has fulfilled its best execution obligations. The conflicts of interest inherent in soft dollar arrangements require boards to pay particular attention to investment advisers' activities in this regard to ensure that fund assets are being used appropriately on behalf of the fund.

Section 15(c) under the Investment Company Act

In addition to their oversight and monitoring responsibilities with respect to portfolio trading and the conflicts of interest associated with soft dollar programs, fund directors have an obligation to review the adviser's compensation. This requirement stems from the requirement in section 15(c) of the Investment Company Act that the independent members of the board review the fund's investment advisory contract on an annual basis. A fund board's review of the adviser's compensation under section 15(c) should incorporate consideration of soft dollar benefits that the adviser receives from fund brokerage. In considering the advisory contract for approval, fund boards are required under section 15(c) to request and evaluate such information as may reasonably be necessary to evaluate the terms of the contract, and the adviser to the fund has the obligation to furnish to the board the information necessary to review the contract.

Although fund boards typically review the use of fund brokerage by the adviser (including the adviser's use of soft dollars) during the contract review process,

Commission examinations show wide variations in board practices in this area. In many cases, fund boards are provided with Part II of the adviser's Form ADV. While

Form ADV provides important information regarding the investment adviser, the Form ADV disclosure requirement was not designed for the purpose of providing fund directors with all of the information needed to help them satisfy board obligations under section 15(c) of the Investment Company Act. In order to fulfill their obligations in connection with the section 15(c) review process, fund boards often seek additional information on soft dollars. However, the types of additional information a board may require may vary depending on factors such as: (i) the scope and nature of the soft dollar program; (ii) the level of clarity and utility of the materials provided; (iii) the board's confidence in the adviser's relevant policies and procedures; and (iv) the adviser's compliance record. For example, information directors seek may range from simple reports on the cost of third-party soft dollar services to detailed reports on all fund portfolio securities transactions, including transaction volumes, soft dollar credits, services provided, and broker reviews.

To assist fund boards in carrying out their responsibilities under section 15(c), the Commission believes it is appropriate for fund boards to request certain information regarding the adviser's use of fund brokerage, including soft dollar arrangements. Specifically, fund directors should require investment advisers, at a minimum, to provide them with information regarding the adviser's brokerage policies, and how a fund's brokerage commissions, and, in particular, the adviser's use of soft dollar commissions, were allocated, at least on an annual basis. Fund directors, in turn, should consider this information when they evaluate the terms of the advisory contract for the fund. Fund directors should, for example, consider whether the adviser properly accounts for use of fund brokerage commissions to purchase research that primarily or solely benefits another client of the adviser.

Disclosure to Other Advisory Clients and Fund Investors

The proposed guidance is designed to provide fund directors with information that will help them fulfill their oversight obligations with respect to the trading practices of the fund's investment adviser, including the adviser's use of soft dollars. The fact that the guidance is focused on fund boards should not be interpreted as an indication that the current level of soft dollar disclosure that is provided to other advisory clients and fund investors cannot be improved.

Summary

The guidance that is being proposed reflects the Commission's view of the critical role fund boards play in managing the adviser's conflicts of interest. The Commission requests general comment on the proposed guidance. In addition, the Commission specifically requests comment on whether: (i) further disclosure to fund investors of the information fund boards should consider would be helpful; (ii) any specific disclosure should be mandated to better assist investors in making informed investment decisions; and (iii) the public dissemination of particular information regarding a fund adviser's portfolio trading practices would have an adverse impact on the fund adviser's relationships with the broker-dealers that execute fund portfolio transactions.

The Commission also requests comment on whether they should again consider proposing to require investment advisers to provide their clients with customized information about how their individual brokerage is being used. If so, what types of information would be useful and in what detail? Should the information provided be different for institutional and non-institutional clients? Do institutional clients already require their advisers to provide information to them about soft dollars on a regular basis, and if so, what kind of information do they receive? What are the cost implications of requiring individual client reports?

SEC – Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies

Background

The Securities and Exchange Commission is reopening the period for public comment on amendments it originally proposed in Securities Act Release No. 8861 (Nov. 21, 2007) [72 FR 67790 (Nov. 30, 2007)]. The rule proposal would, if adopted, require key information to appear in plain English in a standardized order at the front of the mutual fund prospectus; and permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act of 1933 by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site.

Summary Information

The Securities and Exchange Commission ("Commission") is reopening the period for public comment on proposed rule and form amendments that are intended to enhance the disclosures that are provided to mutual fund investors. These amendments were proposed on November 21, 2007, and the comment period initially closed on February 28, 2008. The Commission's proposal would, if adopted, require key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus. The proposals also would permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act of 1933 by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site. Upon an investor's request, mutual funds would also be required to send the statutory prospectus to the investor.

The Commission recently engaged a consultant to conduct focus group interviews and a telephone survey concerning investors' views and opinions about various disclosure documents filed by companies, including mutual funds. During this process, investors participating in focus groups were asked questions about, among other things, a hypothetical summary prospectus. Investors participating in the telephone survey were asked questions relating to several disclosure documents, including mutual fund prospectuses. A comment file has been placed online (available at http://www.sec.gov) for the proposed rule the following documents from the investor testing that relate to mutual fund prospectuses and the proposed summary prospectus: (1) the consultant's report concerning focus group testing of the hypothetical summary prospectus and related disclosures; (2) transcripts of focus groups relating to the hypothetical summary prospectus and related disclosures; (3) disclosure examples used in these focus groups; and (4) an excerpt from the consultant's report concerning the telephone survey of individual investors. In order to provide all persons who are interested in this matter an opportunity to comment on these additional materials, the Commission believes that it is appropriate to reopen the comment period before action is taken on the proposal.

EBSA – Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans

Background

On July 23, 2008 the Employee Benefits Security Administration released a new proposal pertaining to the fiduciary requirements for disclosures in participant-directed plans. This document contains a proposed regulation under the Employee Retirement Income Security Act of 1974 (ERISA) that, upon adoption, would require the disclosure of certain plan and investment-related information, including fee and expense information, to participants and beneficiaries in participant-directed individual account plans (e.g., 401(k) plans). This proposal is intended to ensure that all participants and beneficiaries in participant-directed individual account plans have the information they need to make informed decisions about the management of their individual accounts and the investment of their retirement savings. This document also contains proposed conforming changes to the regulations applicable to ERISA section 404(c) plans (29 CFR 2550.404c-1). Upon adoption, these proposals will affect plan sponsors, fiduciaries, participants and beneficiaries of participant-directed individual account plans, as well as providers of services to such plans. The Department proposes that the regulations and amendments contained in this notice be effective for plan years beginning on or after January 1, 2009.

Information

According to the Department's most recent data, there are an estimated 437,000 participant-directed individual account plans, covering an estimated 65 million participants, and holding almost $2.3 trillion in assets. With the proliferation of these plans, which afford participants and beneficiaries the opportunity to direct the investment of all or a portion of the assets held in their individual plan accounts, participants and beneficiaries are increasingly responsible for making their own retirement savings decisions. This increased responsibility has led to a growing concern that participants and beneficiaries may not have access to, or if accessible, may not be considering information critical to making informed decisions about the management of their accounts, particularly information on investment choices, including attendant fees and expenses.

Under ERISA, the investment of plan assets is a fiduciary act governed by the fiduciary standards in ERISA section 404(a)(1)(A) and (B), which require fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries. Where a plan assigns investment responsibilities to the plan's participants and beneficiaries, it is the view of the Department that plan fiduciaries must take steps to ensure that participants and beneficiaries are made aware of their rights and responsibilities with respect to managing their individual plan accounts and are provided sufficient information regarding the plan, including its fees and expenses, and designated investment alternatives, including fees and expenses attendant thereto, to make informed decisions about the management of their individual accounts. To some extent, such disclosures are already required by plans that elect to comply with the requirements of section 404(c). However, compliance with section 404(c)'s disclosure requirements is voluntary and does not extend to participants and beneficiaries in all participant-directed individual account plans.

The Department believes that all participants and beneficiaries with the right to direct the investment of assets held in their individual plan accounts should have access to basic plan and investment information. For this reason, the Department is issuing this proposed regulation under section 404(a), with conforming amendments to the regulations under section 404(c). These proposals would establish uniform, basic disclosures for such participants and beneficiaries, without regard to whether the plan in which they participate is a section 404(c) plan. In addition, the proposal would require participants and beneficiaries to be provided investment-related information in a form that encourages and facilitates a comparative review among investment options.

To facilitate the development of a proposed regulation, the Department published, on April 25, 2007, a Request for Information (RFI) in the Federal Register requesting suggestions, comments and views from interested persons on a variety of issues relating to the disclosure of plan and investment-related fee and expense and other information to participants and beneficiaries in participant-directed individual account plans. The Department received and reviewed 106 comment letters on these important issues.

Overview of Proposal

1. General

Paragraph (a) of proposed Sec. 2550.404a-5 sets forth the general principle that, where documents and instruments governing an individual account plan provide for the allocation of investment responsibilities to participants and beneficiaries, plan fiduciaries, consistent with ERISA section 404(a)(1)(A) and (B), must take steps to ensure that such participants and beneficiaries, on a regular and periodic basis, are made aware of their rights and responsibilities with respect to the investment of assets held in, or contributed to, their accounts and are provided sufficient information regarding the plan, including plan fees and expenses, and regarding designated investment alternatives available under the plan, including fees and expenses attendant thereto, to make informed decisions with regard to the management of their individual accounts. As discussed below, the proposal addresses the information that must be provided participants and beneficiaries, as well as timeframes for providing that information.

Paragraph (b) of the proposal addresses the disclosure requirements that must be met by plan fiduciaries for plan years beginning on or after January 1, 2009. Under this paragraph, plan fiduciaries must comply with the requirements of paragraph (c), dealing with plan-related information, and paragraph (d), dealing with investment-related information. Paragraph (e) describes the form in which the required information may be disclosed, such as via the plan's summary plan description, a quarterly benefit statement, or the use of the provided model, depending on the specific information. Paragraph (e) merely recognizes various acceptable means of disclosure; it does not preclude other means for satisfying disclosure duties under the proposed regulation. Fiduciaries that meet the requirements of paragraphs (c) and (d) will have satisfied the duty to make the regular and periodic disclosures described in paragraph (a) of this section.

The Department believes, as an interpretive matter, that ERISA section 404(a)(1)(A) and (B) impose on fiduciaries of all participant-directed individual account plans a duty to furnish participants and beneficiaries information necessary to carry out their account management and investment responsibilities in an informed manner. In the case of plans that elected to comply with section 404(c) before finalization of this proposal, the requirements of section 404(a)(1)(A) and (B) typically would have been satisfied by compliance with the disclosure requirements set forth at 29 CFR Sec. 2550.404c
1(b)(2)(i)(B). However, the Department expresses no view with respect to plans that did not comply with section 404(c) and the regulations thereunder as to the specific information that should have been furnished to participants and beneficiaries in any time period before this regulation is finalized.

2. Plan-Related Information

In general, paragraph (c) of the proposal sets forth what is characterized as ``plan-related'' information. This information falls into three categories--general plan information, administrative expense information and individual expense information. Paragraph (c) also describes when this information must be provided to participants and beneficiaries and requires that it be based on the latest information available to the plan.

First, paragraph (c)(1) of the proposal provides for the disclosure of general plan information regarding: How participants and beneficiaries may give investment instructions; any specified limitations on such instructions, including any restrictions on transfer to or from a designated investment alternative; the exercise of voting, tender and similar rights appurtenant to an investment in a designated investment alternative as well as any restrictions on such rights; the specific designated investment alternatives offered under the plan; and any designated investment managers to whom participants and beneficiaries may give investment directions. Under the proposal, this information is required to be furnished to an individual on or before the date he or she becomes eligible to be a participant or beneficiary under the plan and at least annually thereafter. In addition, the proposal requires that participants and beneficiaries be furnished a description of any material changes to the required information not later than 30 days after the date of adoption of such changes. The Department believes that, by referencing the ``date of adoption,'' the regulation will increase the likelihood that participants and beneficiaries will be provided notification of material changes in advance of the changes becoming effective, thereby putting them in a better position to consider such changes (e.g., changes in designated investment alternatives) in managing their accounts. Paragraph (e)(1) of the proposal provides that the disclosures required by this paragraph (c)(1) may be made as part of the plan's summary plan description, provided that the applicable timing requirements are satisfied.

Second, paragraph (c)(2)(i) sets out the required disclosures for administrative expenses. Specifically, it provides that, on or before the date of an individual's eligibility to become a participant or beneficiary under the plan, and at least annually thereafter, participants and beneficiaries must be furnished an explanation of any fees and expenses for plan administrative services (e.g., legal, accounting, recordkeeping) that, to the extent not included in investment-related fees and expenses, may be charged against the individual accounts of participants or beneficiaries and the basis on which such charges will be allocated to, or affect the balance of, each individual account (e.g., pro rata, per capita). This requirement is intended to ensure that the plan fiduciary informs all participants and beneficiaries about the plan's day-to-day operational expenses that will be charged against their accounts. Because of its general nature, the information described in paragraph (c)(2)(i) may, pursuant to paragraph (e)(1) of the proposal, be disclosed as part of the plan's summary plan description, provided that the applicable timing requirements are met.

In addition to the general disclosures concerning plan administrative expenses, paragraph (c)(2)(ii) of the proposal requires that, at least quarterly, participants and beneficiaries be furnished statements of the dollar amounts actually charged during the preceding quarter to the participants' or beneficiaries' accounts for administrative services, and general descriptions of the services to which the charges relate. The statements should be sufficiently specific to inform the participants or beneficiaries of the actual charge(s) to their accounts and enable them to distinguish the administrative services from other charges and services that may be assessed against their accounts. An identification of the total administrative fees and expenses assessed during the quarter, with, for example, an indication that the charges for plan administrative expenses include legal, accounting, and recordkeeping costs to the plan, would be sufficient. The Department does not believe that it is necessary, or particularly useful, for participants to have administrative charges broken out and listed on a service-by-service basis.

Third, paragraph (c)(3) describes the required disclosures for individual expenses. This is identical to paragraph (c)(2) except that it focuses on the disclosure of information relating to individual expenses, i.e., expenses that are assessed on an individual-by-individual, rather than plan-wide, basis. Such expenses might be attendant to a qualified domestic relations order, a participant loan, or investment advice services. Paragraph (c)(3)(i) requires the disclosure of information concerning what expenses might be assessed and paragraph (c)(3)(ii) requires the disclosure of amounts actually assessed and identification of the service to which an expense relates. Also, like paragraph (c)(2), information described in paragraph (c)(3)(i) may be disclosed in the plan's summary plan description and the information described in paragraph (c)(3)(ii) may be included in a quarterly benefit statement.

The Department invites comments on the type of information required to be disclosed, the timing of the information required to be disclosed and the form in which the information may be disclosed.

3. <u>Investment-Related Information</u>

Paragraph (d) of the proposal sets forth the investment-related information required to be furnished or made accessible to participants and beneficiaries in participant-directed individual

account plans. Paragraph (d)(1) sets forth the investment-related information required to be automatically furnished to each participant and beneficiary.
Paragraph (d)(2) addresses the format of the required information.
Paragraph (d)(3) addresses the furnishing of post-investment information. And paragraph (d)(4) sets forth information required to be furnished only upon the request of a participant or beneficiary.

Paragraph (d)(1) provides that, on or before the date of eligibility and at least annually thereafter, participants and beneficiaries must be furnished certain basic information with respect to each designated investment alternative offered under the plan. For purposes of the proposal, paragraph (h)(1) defines the term ``designated investment alternative'' to mean any investment alternative designated by the plan into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term ``designated investment alternative'' does not include ``brokerage windows,'' ``self-directed brokerage accounts,'' or similar plan arrangements that enable participants and beneficiaries to select investments beyond those designated by the plan.

For purposes of identifying the information essential for participants and beneficiaries to consider in evaluating their investment choices under the plan, the Department carefully reviewed the many comments received in response to the RFI, as well as the Commission's proposal for a summary prospectus. The majority of RFI commenters believe that, in addition to basic fee and expense information, participants and beneficiaries need additional disclosure to put fee-related information into context and to educate them about a plan's investment alternatives. On the basis of its review, the
Department concluded that fee and expense information, although important, is only one of the factors to be considered in making informed investment decisions along with investment performance and other information relating to a designated investment alternative.

Specifically, paragraph (d)(1) requires the following disclosures with respect to each designated investment alternative under the plan:

Paragraph (d)(1)(i) requires, among other items, the name and category (e.g., money market mutual fund, balanced fund, index fund, and whether the investment alternative is actively or passively managed) of the designated investment alternative and an Internet Web site address that is sufficiently specific to lead participants and beneficiaries to supplemental information regarding the investment alternative, including its principal strategies, risks, performance and costs. For example, such information may be contained in a Commission-required prospectus (or other document) made available at a Web site address. The Department believes that ready access to such information via the Internet alleviates the need to automatically furnish otherwise important, detailed investment-related information directly to every participant and beneficiary. This accommodates different levels of participant interest in such information. The Department recognizes that, while many investment fund providers do maintain Web sites to inform interested investors concerning specific investment funds, other providers of investment funds and products may not.

Paragraph (d)(1)(ii) of the proposal requires the disclosure of specified performance data for each of the plan's designated investment alternatives. For designated investment alternatives with respect to which the return is not fixed, e.g., an equity index fund, the fiduciary (or designee) must provide the average annual total return (expressed as a percentage) of the investment for the following periods, if available: 1-year, 5-year, and 10-year, measured as of the end of the applicable calendar year; as well as a statement indicating that an investment's past performance is not necessarily an indication of how the investment will perform in the future. For this purpose, the term ``if available'' is intended merely to reflect that some plan investments may not have been in existence for 1, 5, or 10 years. In such cases, plans are expected to explain that the data is not available for this reason (e.g., ``not applicable'' or ``not available''). In the case of designated investment alternatives for which the return is fixed for the term of the investment, e.g., a guaranteed investment contract, the fiduciary (or designee) must provide both the fixed rate of return and the term of the investment. For purposes of paragraph (d)(1)(ii), the term ``average annual total return'' is defined in section (h)(2) of the proposal by reference to standards applicable to open-end management investment companies registered under the Investment Company Act of 1940 (the 1940 Act).

As a corollary to the disclosure of performance data, paragraph (d)(1)(iii) requires disclosure of performance data for an appropriate broad-based benchmark over time periods that are comparable to the performance data periods required under paragraph (d)(1)(ii). As structured, the proposal provides flexibility in identifying an appropriate benchmark. In general, the Department expects that most plans will simply identify the performance benchmark already being used for the investment option pursuant to the Commission's prospectus requirements, if applicable.

Paragraph (d)(1)(iv) specifically addresses the disclosure of fees and expenses attendant to the purchase, holding and sale of each of the plan's designated investment alternatives. For designated investment alternatives with respect to which the return is not fixed, the fiduciary (or designee) must provide: (A) The amount and a description of each shareholder-type fee (i.e., fees charged directly against a participant's or beneficiary's investment), such as sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees, purchase fees, and mortality and expense fees; (B) the total annual operating expenses of the investment expressed as a percentage (e.g., expense ratio); and (C) a statement indicating that fees and expenses are only one of several factors that participants and beneficiaries should consider when making investment decisions. In the case of designated investment alternatives with respect to which the return is fixed for the term of the investment, the fiduciary (or designee) must provide the amount and a description of any shareholder-type fees that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part. The description of each shareholder-type fee must include the amount on which the charge is applied, e.g., 4% of amount invested. For purposes of paragraph (d)(1)(iv), the term ``total annual operating expenses'' is defined in paragraph (h)(3) of the proposal by reference to standards applicable to open-end management investment companies registered under the 1940 Act.

The Department has differentiated the fee and expense disclosures required for designated investment alternatives with returns that vary over time from alternatives with fixed returns based on the financial nature of each of these investment types. While the disclosure requirements for investments with respect to which the return is not fixed are more comprehensive, the Department decided that the most essential information for participants who choose to invest in fixed investment alternatives is the contractual interest rate paid to their accounts and the term of the investment during which their monies are shielded from market price fluctuations and reinvestment risks. Any fees assessed, of course, are factored into determining the contractual interest rate and RFI commentary suggested that there would be little benefit to participants to disclosing such fees for investments with fixed returns.

Paragraph (d)(1)(v) provides that, for purposes of the requirement that participants be provided information on or before the date they are eligible to be covered under the plan, plan fiduciaries may provide such participants the most recent annual disclosure furnished to participants and beneficiaries pursuant to paragraph (d)(1), in addition to any material changes to the information described in paragraph (c)(1)(i). This provision ensures that new participants receive at least the same information that has been furnished to other plan participants and beneficiaries with respect to the designated investment alternatives under the plan. It also avoids the possible burdens and costs of a requirement that fiduciaries update the required disclosures for each new plan participant, which could result in a daily updating requirement for many plans.

Paragraph (d)(2) of the proposal requires the fiduciary to furnish the information required by paragraph (d)(1) in a chart or similar format that will permit straightforward comparison of the plan's designated investment alternatives by participants and beneficiaries.

In response to commenters on the RFI, the Department has developed a model disclosure form that can be used for purposes of satisfying the disclosure requirements of paragraph (d)(2) of the proposal. The model appears in the Appendix to this regulation. Paragraph (e)(3) of the proposal specifically provides that a fiduciary that uses and accurately completes the model format set forth in the Appendix will be deemed to have satisfied the requirements of paragraph (d)(2) relating to the disclosure of the information in paragraph (d)(1) in a comparative form. The Department notes that the proposal would not mandate use of the model as the exclusive means for satisfying the requirement to provide a chart or similar format that facilitates comparison. This proposal provides fiduciaries with the flexibility to create a chart or comparative format of their own design, provided the required information is displayed in a manner facilitating comparisons.

Paragraph (d)(3) of the proposal requires that when a plan provides for the pass-through of voting, tender and similar rights, the fiduciary must furnish participants and beneficiaries who have invested in a designated investment alternative with these features any materials about such rights that have been provided to the plan. This requirement is similar to the requirement currently applicable to section 404(c) plans. See Sec. 2550.404c-1(b)(2)(i)(B)(1)(ix).

Paragraph (d)(4) of the proposal requires a fiduciary to furnish certain identified information either automatically or upon request by participants and beneficiaries, based on the latest information available to the plan. This provision is modeled on the requirements currently applicable to section 404(c) plans with respect to information to be furnished upon request of a participant or beneficiary. See Sec. 2550.404c-1(b)(2)(i)(B)(2).

<u>4. Timing of Disclosures</u>

As discussed above, each of the various disclosures must be made within specific timeframes. The plan-related information concerning certain administrative procedures and expenses required by subparagraphs (c)(1)(i), (c)(2)(i), (c)(3)(i), and the investment-related information required by subparagraph (d)(1) must be provided to each participant or beneficiary ``on or before the date of plan eligibility'' and ``at least annually thereafter.'' The proposal defines ``at least annually thereafter" in paragraph (h)(4) to mean at least once in any 12-month period, without regard to whether the plan operates on a calendar or fiscal year basis.

The proposal also requires that certain information be provided to participants and beneficiaries on a more frequent basis. Specifically, the actual dollar amounts charged to an individual's account during the preceding quarter for administrative and individual services must be disclosed in a statement to participants and beneficiaries ``at least quarterly" pursuant to subparagraphs (c)(2)(ii) and (c)(3)(ii) of the proposal. The proposal defines ``at least quarterly" in paragraph (h)(5) to mean at least once in any 3-month period.

5. Other Fiduciary Duties
Paragraph (f) makes clear that nothing in the regulation would relieve a fiduciary of its responsibilities to prudently select and monitor service providers to the plan and the investments made available under the plan (i.e., designated investment alternatives).

Proposed Amendments to Sec. 2550.404c-1
Also included in this notice are proposed amendments to the regulation under section 404(c) of ERISA, 29 CFR Sec. 2550.404c-1. The proposed amendments to section 2550.404c-1(b), (c) and (f) would integrate the disclosure requirements in the section 404(c) regulation with the new proposed section 2550.404a-5 disclosure requirements and thereby avoid having different disclosure rules for plans intending to comply with the section 404(c) requirements. In brief, the proposed amendments to the section 404(c) regulation eliminate references to disclosures encompassed in the new Sec. 2550.404a-5 proposal and incorporate cross-references to the new proposal, thereby establishing a uniform disclosure framework for all participant-directed individual account plans. The Department also is taking this opportunity to reiterate its long held position that the relief afforded by section 404(c) and the regulation thereunder does not extend to a fiduciary's duty to prudently select and monitor designated investment managers and designated investment alternatives under the plan. Accordingly, it is the Department's view that a fiduciary breach or an investment loss in connection with the plan's selection of a designated investment alternative is not afforded relief under section 404(c) because it is not the result of a participant's or beneficiary's exercise of control. The Department is proposing to amend paragraph (d)(2) (entitled ``Limitation on liability of plan fiduciaries") of Sec. 2550.404c-1 to add a new subparagraph (iv) providing that, ``[P]aragraph (d)(2)(i) does not relieve a fiduciary from the duty to prudently select and monitor any designated investment manager or designated investment alternative offered under the plan."

OCC, Federal Reserve, FDIC, and the OTS (The Agencies) – Supervisory Guidance: Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Basel II Advanced Capital Framework

Background
The Agencies are publishing guidance regarding the supervisory review process for capital adequacy (Pillar 2) provided in the Basel II advanced approaches final rule, which was published in the Federal Register on December 7, 2007 (advanced approaches final rule). The supervisory review process described in this guidance outlines the agencies' standards for (i) satisfying the qualification requirements provided in the advanced approaches final rule; (ii) addressing the

limitations of the minimum risk-based capital requirements for credit risk and operational risk; (iii) ensuring that each institution has a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining appropriate capital levels; and (iv) encouraging each institution to improve its risk identification and measurement techniques. This supervisory guidance applies to any bank, savings association, or bank holding company[1] implementing the advanced approaches final rule.

The Agencies issued a notice of proposed rulemaking (NPR) on September 25, 2006, seeking comment on a new risk-based capital adequacy framework that requires some and permits other qualifying banks to use an internal ratings-based (IRB) approach to calculate regulatory capital requirements for credit risk and certain advanced measurement approaches (AMA) to calculate regulatory capital requirements for operational risk (together, the IRB and the AMA are referred to as the "advanced approaches"). On December 7, 2007, the Agencies published the advanced approaches final rule. The advanced approaches final rule is based largely on a series of publications by the Basel Committee on Banking Supervision (BCBS) that culminated in a comprehensive release in June 2006, titled, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (New Accord). The New Accord presents a three-pillar framework for determining risk-based capital requirements for credit risk, market risk, and operational risk (Pillar 1); supervisory review of capital adequacy (Pillar 2); and market discipline through enhanced public disclosure (Pillar 3).

On February 28, 2007, the agencies published in the Federal Register three separate documents proposing supervisory guidance related to the implementation of the advanced approaches. Two of those documents provided guidance for certain aspects of Pillar 1, that is, for the IRB systems for determining the credit risk of retail and wholesale exposures, and other systems for equity and securitization exposures, and for the AMA for determining operational risk. The third document proposed guidance for Pillar 2. This final guidance document provides supervisory guidance only for Pillar 2, and it does not provide Pillar 1 guidance on the systems for determining regulatory capital requirements for credit risk or for determining regulatory capital requirements for operational risk. This document does not differ significantly from the proposed Pillar 2 guidance.

The Agencies recognize that a number of institutions may need additional guidance to implement the advanced approaches final rule. Accordingly, consistent with the proposed guidance for Pillar 2, this guidance document highlights certain aspects of existing supervisory review that are being augmented or clarified to support the implementation of the supervisory assessment of overall capital adequacy under the advanced approaches final rule. In making this assessment, the agencies will consider, among other items, whether each institution (i) has satisfied the qualification requirements for implementing the advanced approaches; (ii) has a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining appropriate capital levels (internal capital adequacy assessment process -- ICAAP); and (iii) maintains a satisfactory risk management and control structure, consistent with its capital position and overall risk profile.

Information

Supervisory Review Process of Capital Adequacy (Pillar 2) Related to the Implementation of the Advanced Approaches Final Rule

1. This guidance supplements the final rule published jointly by the U.S. Federal banking agencies[1] in the Federal Register on December 7, 2007 (advanced approaches rule). The advanced approaches rule implements a new risk-based capital framework encompassing three pillars:

- minimum risk-based capital requirements (Pillar 1);
- supervisory review (Pillar 2); and
- market discipline through enhanced public disclosures (Pillar 3).

The minimum risk-based capital requirements in Pillar 1 of the advanced approaches rule apply to a bank's calculation of minimum risk-based capital requirements for credit risk and operational risk. If the bank is also subject to the market risk rule, then the minimum risk-based capital requirements in that rule would apply.

2. This document addresses the process for supervisory review in the advanced approaches rule. As described in this guidance, supervisory review covers three main areas:

- comprehensive supervisory review of capital adequacy;
- compliance with regulatory capital requirements; and
- internal capital adequacy assessment process (ICAAP).

3. The process of supervisory review described in this guidance reflects a continuation of the longstanding approach employed by the agencies in their supervision of banks. However, because implementation of the advanced approaches rule affects certain aspects of supervisory review, this guidance highlights areas of existing supervisory review that are being augmented or more clearly defined to support implementation of the advanced approaches rule by U.S. banks.

4. The supervisory review process described in this document is intended to help ensure overall capital adequacy by:

- confirming a bank's compliance with regulatory capital requirements;
- addressing the limitations of minimum risk-based capital requirements as a measure of a bank's full risk profile – including risks not covered or not adequately addressed or quantified in Pillar 1;
- ensuring that each bank is able to assess its own capital adequacy (beyond minimum risk-based capital requirements) based on its risk profile and business model; and
- encouraging banks to develop and use better techniques to identify and measure risk.

5. This guidance neither supersedes nor alters the functioning of the existing Prompt Corrective Action requirements. Similarly, this guidance does not affect any other requirements for compliance with existing regulations and supervisory standards related to risk-management practices or other areas. The supervisory review process described in this guidance supports the supervisors' existing ability to:

- require an individual bank to take measures to prevent its capital from falling below the level needed to adequately support its risks; or
- otherwise intervene to ensure that the bank's capital levels are adequate.

Comprehensive Supervisory Review of Capital Adequacy

6. Capital helps protect individual banks from insolvency, thereby promoting safety and soundness in the overall U.S. banking system. Minimum risk-based capital requirements establish a threshold below which a sound bank's risk-based capital must not fall. Risk-based capital ratios permit some comparative analysis of capital adequacy across banks because they

are based on certain common assumptions. However, supervisors must perform a more comprehensive review of capital adequacy that considers the risks that are specific to each individual bank, including those not incorporated in risk-based capital requirements. In short, supervisors must ensure that a bank's overall capital does not fall below the level required to support its entire risk profile.

7. Supervisors generally expect banks to hold capital above their minimum risk-based capital levels, commensurate with their individual risk profiles, to account for all material risks. Going forward under the advanced approaches rule, supervisors will continue to review the overall capital adequacy of any bank through a comprehensive evaluation that considers all relevant available information. In determining the extent to which banks should hold capital in excess of risk-based capital minimums, supervisors will consider: the combined implications of a bank's compliance with qualification requirements for regulatory capital standards; the quality and results of a bank's own process for determining whether capital is adequate (the ICAAP); and the bank's risk-management processes, control structure, and other relevant information relating to the bank's risk profile and capital level. This review is consistent with current supervisory practice, under which the agencies assess a bank's overall capital adequacy through a comprehensive evaluation of all relevant information.

8. The supervisory review process assesses whether a bank has a satisfactory process to determine that its overall capital is adequate, and that the bank maintains adequate capital on an ongoing basis, as underlying conditions change. For example, changes in a bank's risk profile or in relevant capital measures are areas of particular focus that are effectively addressed through the supervisory review process. Generally, a bank should hold more capital for material increases in risk that are not otherwise mitigated, unless the bank already holds capital at a level exceeding what its internal processes and supervisors would regard as adequate. Conversely, a bank may be able to reduce overall capital (to a level still above regulatory minimums) if the supervisory review supports the conclusion that the bank's inherent risk has materially declined or that it has been appropriately mitigated.

9. As a result of its comprehensive supervisory review, a bank's primary Federal supervisor may take action if it is not satisfied that capital is adequate. The primary Federal supervisor may require the bank to take actions to address identified supervisory concerns, which may include requiring the bank to hold additional capital to bring capital to levels that the supervisor deems commensurate with the bank's risk profile. In addition, the primary Federal supervisor may, under its enforcement authority, require a bank to modify or enhance risk- management and internal-control processes, reduce its exposure to risk, or take any action deemed necessary to address identified supervisory concerns.

<u>Compliance with Regulatory Capital Requirements</u>

10. In order to use the advanced approaches rule to calculate minimum risk-based capital requirements, a bank must meet certain process and systems requirements. As part of the supervisory review process, the agencies will ensure that each bank meets these requirements. The advanced approaches rule provides an explanation of these qualification requirements for any systems and processes used.

11. A bank using the advanced approaches rule must comply with the rule's qualification requirements for both initial and ongoing qualification. A bank that falls out of compliance with

the qualification requirements would be required to establish a plan to return to compliance that satisfies its primary Federal supervisor.

12. Supervisors will ensure that each bank using the advanced approaches rule complies with the qualification requirements both at the consolidated level and at any subsidiary bank that uses the advanced approaches rule. Thus, each bank that applies the advanced approaches rule must have appropriate risk-measurement and risk-management processes and systems that meet the rule's qualification requirements.

The ICAAP

13. The qualification requirements in the advanced approaches rule state that "a bank must have a rigorous process for assessing its overall capital adequacy in relation to its risk profile and a comprehensive strategy for maintaining an appropriate level of capital." Because minimum risk-based capital requirements are based on certain assumptions and address only a subset of risks faced by an individual bank, each bank must conduct an internal assessment of whether its capital is adequate, given its risk profile. A bank must conduct this assessment, using the ICAAP, in addition to its calculation of minimum risk-based capital requirements. Accordingly, a bank's capital should exceed the level required by its minimum risk-based capital requirements, and also should be adequate according to its own ICAAP.

14. The fundamental objectives of a sound ICAAP are:

- identifying and measuring material risks;
- setting and assessing internal capital adequacy goals that relate directly to risk; and
- ensuring the integrity of internal capital adequacy assessments.

15. Assessing overall capital adequacy through the ICAAP requires thorough identification of all material risks, measurement of those that can be reliably quantified, and systematic assessment for the limitations of minimum risk-based capital requirements. The ICAAP should address the capital implications arising from both on- and off-balance sheet positions, as well as from provisions of explicit or implicit support. Material risks include those that in isolation do not appear to be material at first, but when combined with other risks could lead to material losses. In this manner, the ICAAP should contribute broadly to the development of better risk management within the organization at both the individual entity and consolidated levels.

16. Each bank implementing the advanced approaches rule should have an ICAAP that is appropriate for its unique risk characteristics and should not rely solely upon the assessment of capital adequacy at the parent company level. This does not preclude the use of a consolidated ICAAP as an important input to a subsidiary bank's own ICAAP, provided that each entity's board and senior management ensure that the ICAAP is appropriately modified to address the unique structural and operating characteristics and risks of the subsidiary bank.

17. In general, the ICAAP will likely go beyond the assumptions built into minimum risk-based capital requirements. However, in certain instances a bank's ICAAP – when supported by proper justification and evidence – may build upon and utilize the methods, practices, and results it uses to determine minimum risk-based capital requirements. For example, in developing the ICAAP, a bank may choose to use data, ratings, or estimates from internal ratings-based approaches for credit risk; or a bank may choose to use the advanced measurement approaches as the basis for its internal assessment of operational risk. Furthermore, although the ICAAP

should be a distinct and comprehensive process that produces its own capital measures, in some cases a bank may be able to demonstrate that minimum risk-based capital measures appropriately reflect certain aspects of a bank's risk profile and thus are appropriate for use in its ICAAP.

18. The design and operation of any systems used to meet the ICAAP requirements will likely differ, depending on the complexity of each bank's operations and risk profile. Many banks employ "economic capital" measures for some elements of risk management, such as limit setting, or for evaluating performance or determining aggregate capital needs.[10] In some cases, economic capital measures may relate directly to a bank's assessment of capital adequacy under the ICAAP; however, in other cases, a bank may be using economic capital measures that are not intended for capital adequacy assessments. In the latter case, a bank does not necessarily need to change its existing process or systems, but it may need to build upon or adjust its economic capital measures for use in the ICAAP and the bank would have to demonstrate clearly how it does so. Notably, economic capital is not the only means to meet the ICAAP requirement. Regardless of the specific implementation method(s) chosen, the bank's ICAAP should address the three ICAAP objectives listed in paragraph 14.

Identifying and Measuring Material Risks

19. The first objective of the ICAAP is to identify all material risks. Risks that can be reliably measured and quantified should be treated as rigorously as data and methods allow. The appropriate means and methods to measure and quantify those material risks are likely to vary across banks. The key point is for a bank to be able to identify all material risks and measure those that can be reliably quantified in order to determine how those risks affect the bank's overall capital adequacy.

20. Some of the risks to which a bank may be exposed include credit risk, market risk, operational risk, interest rate risk in the banking book, and liquidity risk. Other risks, such as reputational risk, business or strategic risk, and country risk may also be material for a bank and, in such cases, should be given equal consideration to the more formally defined risk types. Additionally, if a bank employs risk mitigation techniques it should understand the risk to be mitigated and the potential effects of that mitigation (including enforceability and effectiveness).

- Credit risk: A bank should have the ability to assess credit risk at the portfolio level in addition to the exposure or counterparty level. In making this assessment, the bank should be particularly attentive to identifying any credit risk concentrations and ensuring that their effects are adequately assessed. The bank should consider the various types of dependence among exposures, and the credit risk effects of extreme outcomes, stress events, and shocks to assumptions about portfolio and exposure behavior. The bank also should carefully assess concentrations in counterparty credit exposures, including those that result from trading in less liquid markets, and determine the effect that these exposures might have on capital adequacy.
- Market risk: A bank should be able to identify risks in trading and capital markets activities resulting from a movement in market prices and rates. This determination should consider factors such as illiquidity of instruments, leverage, concentrated positions, one-way markets, non-linear or deep out-of-the money option positions as well as embedded optionality, and the potential for significant shifts in correlations or other types of dependence structures. Assessments that incorporate extreme events, idiosyncratic variations, credit migrations or changes in credit spreads, defaults, and shocks should also be tailored to capture key portfolio vulnerabilities.

- Operational risk: A bank should be able to assess the potential risks resulting from inadequate or failed internal processes, people, and systems, as well as from events external to the bank. This assessment should include the effects of extreme events and shocks relating to operational risk. Extreme events could include a substantial or sudden increase in failed processes across business units or a significant incidence of failed internal controls.
- Interest rate risk in the banking book: A bank should incorporate interest rate risk in the banking book into its assessment of capital adequacy. In making this assessment, the bank should identify the risks associated with changes in interest rates that impact both on- and off-balance sheet exposures in the banking book from a short- and long-term perspective. This might include the impact of changes due to parallel yield curve shocks, yield curve twists, yield curve inversions, changes in the adjustment of rates earned and paid on different financial instruments with otherwise similar repricing characteristics (basis risk), and other relevant scenarios including some that incorporate stress events, extreme outcomes, and shocks to assumptions. The bank should be able to support any assumptions it has made with respect to the behavioral characteristics of servicing rights, non-maturity deposits, positions subject to prepayment risk, and other assets and liabilities, especially for those exposures characterized by embedded optionality.
- Liquidity risk: A bank should incorporate liquidity risk into the assessment of its capital adequacy. A bank should evaluate whether capital is adequate given its own funding liquidity profile and given the liquidity of the markets in which it operates. This assessment should incorporate various types of liquidity environments and include an evaluation of the potential for a material disruption in the sources of liquidity typically relied on by the bank as a result of bank-specific as well as systemic events. A bank should consider the capital adequacy implications of lacking a well-diversified funding base, relying predominantly on wholesale credit markets for its funding, or relying heavily on volatile funding sources. A bank involved in securitization activities should consider the capital adequacy implications of relying on market liquidity to distribute warehoused assets, including the potential for disruptions that would cause a bank to bring certain items onto its balance sheet. In its assessment of the impact of liquidity risk on capital adequacy, the bank should also challenge assumptions built into its definition of liquid products.

The risk factors discussed above are not an exhaustive list of those affecting any given bank. A well-developed ICAAP should include an assessment of all relevant factors that present a material source of risk to capital, and should account for concentrations within each risk type.

21. A bank should assess whether its capital is sufficient to absorb any losses that may arise from activities that expose the bank to multiple risks within and across business lines or create concentrations across risk types. A bank should recognize that losses could arise in several risk dimensions at the same time, stemming from the same event or a common set of factors. For example, a localized natural disaster could generate losses from credit, market, and operational risks. Additionally, the ICAAP should focus on any complex activities that give rise to multiple risks, and to their interaction. These activities can involve instruments that may be complex, illiquid, or difficult to value. For example, securitization activities expose a bank to a variety of risks that can affect capital adequacy at the same time, including credit, market, liquidity, and reputational risks; structured products can have multiple embedded risks that interact in complex ways and can present losses in multiple risk areas across different business lines at the same

time. In general, the ICAAP should include an assessment of the potential effects of convergence of risks within and across business lines and their combined impact on capital adequacy.

22. The ICAAP should take into consideration the linkage between capital adequacy and damage or potential damage to a bank's reputation. A bank might incur losses affecting capital adequacy because of damage to its reputation, or the bank might incur losses trying to prevent or mitigate damage to its reputation. In assessing the linkage between reputational risk and capital adequacy, a bank should assess risks associated with both on-balance sheet and off-balance sheet exposures and activities, as well as risks associated with affiliates, subsidiaries, counterparties, clients, or other third parties. The assessment should include activities for which the bank acts as a sponsor or advisor, and cases in which the bank provides explicit or implicit support. A bank should also assess the risk of having to assume the losses of a third party to prevent or mitigate damage to the bank's reputation.

23. The bank's ICAAP should assess risks associated with new products, markets and activities. In making this assessment, the bank should account for any uncertainty in the valuation of new products, whether by the bank or a third party, which could be more challenging if the new products are particularly complex or do not have liquid markets. The ICAAP should take into consideration changing dynamics in markets for new products and uncertainty as to how new markets might respond to stress conditions. The ICAAP should also assess the challenges presented by new business lines or strategic acquisitions in terms of their impact on capital adequacy.

24. All measurements of risk should incorporate both quantitative and qualitative elements. Generally, a quantitative approach should form the foundation of a bank's measurement framework. Quantitative approaches that focus on most likely outcomes for budgeting, forecasting, or performance measurement purposes may not be fully applicable for assessing capital adequacy, which also should take less likely outcomes into account.

25. In some cases, quantitative tools can include the use of large historical databases. These databases are most applicable when they are fully reflective of all relevant risk characteristics, incorporate appropriate variability, and have adequate granularity and history; for example, they should include data based not just on benign but also more stressful economic periods or operating environments. When internal data are not available or do not reflect a bank's risk profile, a bank may rely on external data for risk measurements, but should ensure that external data have applicability to the bank's own activities and risk profile.

26. The confidence a bank places in the results of its ICAAP should depend on the quality and robustness of the associated risk assessments. When measuring risks, a bank should understand that estimation and measurement errors are common, and in many cases are themselves difficult to quantify. In general, the bank's ICAAP should reflect an appropriate level of conservatism to account for uncertainty in risk identification, risk mitigation or control, and risk quantification. In most cases, appropriate conservatism will result in greater capital needs.

27. In many cases, risk assessments may rely to a significant degree on models that use both qualitative and quantitative inputs. The use of models can enhance the ICAAP, but it can also introduce challenges. Specifically, models may fail to work as intended or expected, or they may be used inappropriately for purposes not considered in their initial design. These concerns apply

to models purchased from third-party vendors, as well as to models that are internally developed. A bank using models as part of the ICAAP should recognize these possibilities and ensure that appropriate controls, such as rigorous initial and ongoing validation and independent review, are in place to mitigate and manage any risks related to model use. A bank should apply appropriate conservatism to compensate for any risks associated with models. Additional conservatism may be necessary to account for any uncertainties in the use of models to value on- or off-balance sheet exposures or for imperfections and volatility in market-based valuations. Additional conservatism may be necessary to compensate for increased risk, for example, when models or applications are more complex, or when they have a more significant influence on the ICAAP's results.

28. To gain a fuller understanding of the risks beyond more typical quantitative measures – such as those based on certain parameter behavior or distributional assumptions – a bank should also rely on other types of quantitative exercises. For example, stress testing, including scenario analysis and sensitivity analysis, is an additional quantitative exercise that a bank should regularly apply to complement more typical quantitative measures. A bank may need to rely more heavily on such exercises when internal or demonstrably relevant external data are scarce. These exercises can help gauge the consequences of outcomes that are unlikely, but would have a considerable impact on safety and soundness.

29. In addition to quantitative approaches for assessing risk, a bank should also employ qualitative approaches that incorporate management experience and judgment. Qualitative measures should be employed not only for those cases in which scarce data or unproven quantitative methods limit a full assessment of risk, but also more generally to complement even sophisticated quantitative estimates based on extensive and high-quality data.

30. A bank should be cognizant that both quantitative and qualitative approaches have their own inherent biases and assumptions that affect risk assessment. Accordingly, a bank should recognize the biases and assumptions embedded in, and the limitations of, the approaches used.

31. An effective ICAAP is comprehensive, assessing material risks across the entire bank. Each bank should have systems capable of aggregating across risk types. A bank should understand the challenges presented by risk aggregation and the inherent uncertainty in quantitative estimates used to aggregate. For example, a bank is encouraged to consider the various interdependencies among risk types, the different techniques used to identify such interdependencies, and the channels through which those interdependencies might arise – across risk types, within the same business line, and across different business lines. Consistent with paragraph 26, any associated uncertainty in aggregating capital estimates across risk types and business lines should translate into greater capital needs.

32. Management should be systematic and rigorous in considering possible effects of diversification. Assumptions about diversification should be identified at each level where diversification is recognized, supported by analysis and evidence, and remain robust over time and under different market environments, including stressed market conditions. For example, a bank calculating the dependence structure within or among risk types should consider data quality and consistency, such as the volatility of correlations over time and during periods of market stress. In general, a bank should consider a wide range of possible adverse outcomes that have the potential to affect multiple risks at the same time and to limit expected diversification

benefits. Consistent with paragraph 26, uncertainty in diversification estimates should translate into greater capital needs.

Setting and Assessing Capital Adequacy Goals that Relate to Risk

33. The second objective of the ICAAP is to set and assess capital adequacy goals in relation to all material risks. Under this objective, a bank should have a well-defined process to translate estimates of risk into an assessment of capital adequacy. In practice, capital adequacy goals may be reflected in various ways. A bank may choose to hold capital in excess of the level internal processes would regard as adequate for any number of business or strategic reasons. Excess capital may fluctuate over time. Each bank should recognize that minimum risk-based capital requirements represent a floor below which the bank's overall capital level must not fall, even if bank management believes that there is justification to maintain less capital.

34. A bank may establish its risk-tolerance level to reflect a desired level of risk coverage and/or a certain degree of creditworthiness, such as an explicit solvency standard. Accordingly, assessments of risk and capital adequacy should reflect the chosen risk tolerance of the bank. Because risk profiles and choices of risk tolerance may differ across banks, capital targets may also differ. However, if for internal capital adequacy purposes a bank were to choose to apply a level of risk coverage or a solvency standard that is less than that implied by minimum risk-based capital requirements, the bank would have to be able to: identify and support the rationale for a lower solvency standard; demonstrate clearly that its ICAAP adequately addresses low-probability, high-severity events; and ensure that there is sufficient capital to absorb losses associated with such extreme events. Regardless of the solvency standard used, supervisors expect banks to hold capital at a level above that established by minimum risk-based capital requirements.

35. A bank should consider external conditions and other factors that influence its overall capital adequacy, including the potential impact of contingent exposures and changing economic and financial environments. The ICAAP should address the potential impact of broader market or systemic events, which could cause risk to increase beyond the bank's chosen risk-tolerance level, and have appropriate contingency plans for such outcomes. Such exercises may include stress testing, such as scenario and sensitivity analysis; however, in all cases they should incorporate both quantitative and qualitative methods.

36. Through the ICAAP, a bank should ensure that adequate capital is held against all material risks, and that capital remains adequate not just at a point in time, but over time, to account for changes in a bank's strategic direction, evolving economic conditions, and volatility in the financial environment. A bank should be cognizant of the impact of market-driven valuations on the volatility of capital. Moreover, recognizing the sensitivity of capital to economic and financial cycles should be a critical component of a bank's planning for current and future capital needs. For example, a bank should consider the potential effects of a sudden, sustained economic downturn. The level of capital deemed adequate by a bank given its ICAAP might also be influenced by the bank's intention to hold additional capital to mitigate the impact of volatility in capital requirements, its need to support acquisition plans, or its decision to accommodate market perceptions of capital adequacy and their impact on funding costs.

37. In analyzing capital adequacy, a bank should evaluate the capacity of its capital to absorb losses. Because various definitions of capital are used within the banking industry, each bank

should state clearly the definition of capital used in any aspect of its ICAAP. Since components of capital are not necessarily alike and have varying capacities to absorb losses, a bank should be able to demonstrate the relationship between its internal capital definition and its assessment of capital adequacy. If a bank's definition of capital differs from the regulatory definition, the bank should reconcile such differences and provide an analysis to support the inclusion of any capital instruments that are not recognized under the regulatory definition. Although common equity is generally the predominant component of a bank's capital structure, a bank may be able to support the inclusion of other capital instruments in its internal definition of capital if it can demonstrate a similar capacity to absorb losses. The bank should document any changes in its internal definition of capital, and the reason for those changes.

38. An effective capital plan recognizes a bank's short- and long-term capital needs and objectives. Accordingly, a bank should evaluate whether long-run capital targets are consistent with short-run goals, based on current and planned changes in risk profiles. In developing its capital plan, the bank also should recognize that accommodating additional capital needs can require significant lead time, can be costly, or can be quite difficult, especially during downturns or other times of stress. A bank should have contingency plans to address unexpected capital needs.

Ensuring Integrity of Internal Capital Adequacy Assessments

39. A satisfactory ICAAP comprises a complete process with proper oversight and controls, and not just an ability to carry out certain capital calculations. The various elements of a bank's ICAAP should complement and reinforce one another to achieve the overall objective of assessing capital adequacy, taking into account the bank's risk profile.

40. A bank should maintain adequate internal controls to ensure the integrity, objectivity, and consistent application of the ICAAP. Decisions regarding the design and operation of the ICAAP should reflect sound risk management, and should not be unduly influenced by competing business objectives. A bank should identify any deficiencies in its ICAAP and plan and take remedial actions to address the deficiencies in a timely manner. The principles underlying a bank's ICAAP should be incorporated into policies that are reviewed and approved at appropriate levels within the organization.

41. A bank should maintain thorough documentation of its ICAAP to ensure transparency. At a minimum, this should include a description of the bank's overall capital-management process, including the committees and individuals responsible for the ICAAP; the frequency and distribution of ICAAP-related reporting; and the procedures for the periodic evaluation of the appropriateness and adequacy of the ICAAP. In addition, where applicable, ICAAP documentation should demonstrate the bank's sound use of quantitative methods (including model selection and limitations) and data–selection techniques, as well as appropriate maintenance, controls, and validation. A bank should document and explain the role of third-party and vendor products, services and information – including methodologies, model inputs, systems, data, and ratings – and the extent to which they are used within the ICAAP. A bank should have a process to regularly evaluate the performance of third-party and vendor products, services and information. As part of the ICAAP documentation, a bank should document the assumptions, methods, data, information, and judgment used in its quantitative and qualitative approaches.

42. The ICAAP should be enhanced and refined over time, with learning and experience (both quantitative and qualitative) contributing to its improvement. The ICAAP should evolve with changes in the risk profile and activities of the bank, as well as with advances in risk measurement and management practices. For example, a bank should incorporate in its ICAAP the introduction of new products and business lines and activities to ensure that the bank's capital plan is responsive to changes in the operational and/or business environment.

43. The board of directors and senior management have certain responsibilities in developing, implementing, and overseeing the ICAAP. The board should approve the ICAAP and its components. The board or its appropriately delegated agent should review the ICAAP and its components on a regular basis, and approve any revisions. That review should encompass the effectiveness of the ICAAP, the appropriateness of risk tolerance levels and capital planning, and the strength of control infrastructures. Senior management should continually ensure that the ICAAP is functioning effectively and as intended, under a formal review policy that is explicit and well documented. Additionally, a bank's internal audit function should play a key role in reviewing the controls and governance surrounding the ICAAP on an ongoing basis.

44. Each bank should ensure that the components of its ICAAP, including any models and their inputs, are subject to the bank's validation policies and procedures. Validation should be independent of the development, implementation, and operation of the ICAAP components, or the validation process should be subject to an independent review of its adequacy and effectiveness. Validation is generally defined as an ongoing process that includes, but is not limited to, the collection and review of developmental evidence, process verification, benchmarking, outcomes analysis, and monitoring activities used to confirm that processes are operating as designed. Validation policies and procedures should reflect the bank's business, structure, and sophistication, as well as the relative importance of each component of the ICAAP. Accordingly, a bank is encouraged to consult the agencies' existing guidance on validation.

45. A bank's ICAAP should be aligned with and be a part of the bank's wider internal governance structure and overall risk-management processes. The ICAAP should not be viewed as simply a compliance exercise. Rather, it is a dynamic and evolving process that is used by a bank to provide internal assurance that capital is adequate given the bank's risk profile. Management is responsible for ensuring that the ICAAP is fully consistent with the overall risk management framework of the bank. Information derived through the ICAAP process should influence decision making at both the consolidated and individual business-line levels, and be used to inform other management processes related to risk assessment, business planning and forecasting, pricing strategies, and performance measurement.

46. As part of the ICAAP, the board or its delegated agent, as well as appropriate senior management, should periodically review the resulting assessment of overall capital adequacy. This review, which should occur at least annually, should include an analysis of how measures of internal capital adequacy compare with other capital measures (such as regulatory, accounting-based or market-determined). Upon completion of this review, the board or its delegated agent should determine that, consistent with safety and soundness, the bank's capital takes into account all material risks and is appropriate for its risk profile. However, in the event a capital deficiency is uncovered (that is, if capital is not consistent with the bank's risk profile or risk

tolerance) management should consult and adhere to formal procedures to correct the capital deficiency.