The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

**MEMO# 19481**

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# 2005 SECURITIES LAW DEVELOPMENTS CONFERENCE SPEECHES

 [19481] December 16, 2005 TO: BOARD OF GOVERNORS No. 66-05 BROKER/DEALER ADVISORY COMMITTEE No. 37-05 BROKER/DEALER ASSOCIATE MEMBERS No. 14-05 CEOS CHIEF COMPLIANCE OFFICER COMMITTEE No. 67-05 CLOSED-END INVESTMENT COMPANY MEMBERS No. 65-05 COMPLIANCE MEMBERS No. 28-05 SEC RULES MEMBERS No. 127-05 SMALL FUNDS MEMBERS No. 102-05 UNIT INVESTMENT TRUST MEMBERS No. 27-05 RE: 2005 SECURITIES LAW DEVELOPMENTS CONFERENCE SPEECHES Earlier this week, Institute General Counsel Elizabeth Krentzman, Institute Chief Government Affairs Officer, Dan Crowley, NASD Executive Vice President, Elisse Walter, and Williams & Connolly Partner, John Villa, spoke at the Institute's 2005 Securities Law Developments Conference.* Their remarks are briefly summarized below. Remarks by Ms. Krentzman Ms. Krentzman, who provided the conference's opening remarks, began by listing a number of the Institute's accomplishments during the past twelve months. Included in this list was a description of the Institute's new Chief Compliance Officer Committee, an amicus brief filed by the Institute with the U.S. Supreme Court, and the first chapter in the Institute's Fair Valuation Series. Ms. Krentzman also described a soon-to-be released paper for chief compliance officers to help them comply with the compliance rule, Rule 38a-1 under the Investment Company Act of 1940 and the second chapter in the Fair Valuation series, which will discuss the role of fund boards of directors in the fair valuation process. * A copy of Ms. Krentzman's opening remarks is attached to this memo. Mr. Crowley's remarks are available on the Institute's website at http://www.ici.org/home/05_seclaw_crowley_spch.html#TopOfPage. Ms. Walter's remarks are available on NASD's website at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015699&ssSourceNodeId=5. 2 Ms. Krentzman next discussed the Institute's initiatives involving funds as investors. She noted that the Institute was an active participant in the debate over the adoption of Regulation NMS and the New York Stock Exchange's plans to become a "hybrid market," which would incorporate elements of a traditional auction market with those of an electronic market. Ms. Krentzman then remarked that, as with all of its initiatives, the Institute's guiding principle is to protect and promote the interests of the millions of Americans who participate in the markets through mutual funds. She stressed that, looking ahead to 2006, it is imperative the Securities and Exchange Commission and the industry continue to work together to ensure that the regulatory framework that governs mutual funds fully serves the best interests of investors. Ms. Krentzman added that "the best outcome for shareholders can only be achieved by an informed and vigorous dialogue between the industry and our regulators." Next, Ms. Krentzman noted that the

Institute is “particularly pleased” that the SEC staff is reexamining the contract provision of the redemption rule. She also applauded some important changes to the SEC’s inspection program. In closing, Ms. Krentzman remarked that reforming mutual fund disclosure offered a terrific opportunity for the industry and the regulators to join together in a productive dialogue. She stated that the Institute encourages the SEC to undertake a top-to-bottom review of the mutual fund disclosure regime with the goal of improving the effectiveness of required disclosure. As part of this effort, she recommended that the SEC carefully study how to take full advantage of the Internet. Remarks by Mr. Crowley Mr. Crowley began his keynote address by providing an overview of the public policy environment in Washington, DC. He noted President Bush’s recent efforts to incentivize long- term savings and to enhance the retirement security of millions of Americans by reforming the social security system. In particular, Mr. Crowley stated that President Bush has emphasized that private sector solutions are needed to address the long-term solvency of social security. In this regard, he noted the Institute’s recognition that mutual funds are “a critical part – indeed the foundation – of retirement security” because of their supporting role with respect to retirement accounts, such as 401(k)s and IRAs. Mr. Crowley next discussed a number of items on the Institute’s current policy agenda, including issues relating to retirement savings and tax incentives. He noted the Institute’s strong support for the bipartisan “Generating Retirement Ownership Through Long-Term Holding” (GROWTH) Act, which would keep more retirement savings invested and growing longer by deferring taxation of automatically reinvested capital gains until fund shares are sold. Mr. Crowley observed that mutual funds are an important part of American workers’ preparation for retirement, both through their employers’ retirement plans and on their own, and that the “GROWTH Act provides middle income Americans a better tool to grow their long-term retirement savings.” Mr. Crowley remarked that Congress is also exploring the use of tax incentives to encourage retirees to “annuitize” their retirement income. To this end, he noted that Lifetime 3 Payment Accounts, which are systematic withdrawal programs that provide periodic distributions from mutual fund accounts over the investor’s life, would allow retired investors to keep their money at work in the market and to benefit from gains to help offset inflationary risks. Mr. Crowley also discussed tax reconciliation and pension reform measures currently working their way through Congress. He noted that the recent House tax reconciliation bill includes a two-year extension of the 15 percent tax rate on capital gains and dividends. With respect to pension reform legislation, Mr. Crowley discussed the provisions in both the Senate and House versions of the legislation that will impact the mutual fund industry. In closing, Mr. Crowley noted that the Institute is playing a “vitally important role and has proactively advocated a number of sound public policy proposals to benefit investors.” Remarks by Ms. Walter Ms. Walter began her keynote address by noting that, although NASD has no jurisdiction over mutual funds or their advisers, it does regulate the broker-dealers and underwriters who sell funds. In this regard, she stated that NASD is constantly both studying ways to make the sales process work better for investors and devoting considerable resources to investor education and online tools to help Americans understand mutual fund investing. Ms. Walter next discussed the Breakpoint Task Force that, at the request of the SEC, was convened by the NASD, ICI and SIA to examine the difficulties in delivering fund sales charge breakpoint discounts. She noted that, in July 2003, the Breakpoint Task Force issued a report recommending improvements to a variety of practices within the financial services industry to facilitate the delivery of correct breakpoint discounts. In her view, the industry worked hard to implement the report’s recommendations and, as a result, for example, there is now standardized definitions of commonly used terms, better prospectus and web site disclosures concerning breakpoints, better recordkeeping, and required new training of registered representatives. She also added that, as part of the Breakpoint Task Force’s recommendations, NASD, working

closely with the NSCC, developed a central database containing breakpoint information for all funds that impose front-end sales charges. Ms. Walter noted that the database is now significantly populated, thanks to assistance from the Institute, which helped to encourage fund group participation. Given the significant information that is now available, Ms. Walter stated that NASD launched a free online Mutual Fund Breakpoint Search Tool that allows broker-dealers and investors to obtain information about available breakpoints. Ms. Walter also discussed the most recent NASD-industry collaboration, the NASD Mutual Fund Task Force. The Task Force, which was made up of experts from the mutual fund and broker-dealer industries, as well as academicians and attorneys, issued two reports. The first report considered portfolio transaction costs and soft dollars. The second report considered Rule 12b-1 fees and other distribution payments. Ms. Walter noted that NASD was pleased that the SEC's proposed interpretive guidance on soft dollars is largely consistent with the recommendations in the Task Force's first report. With respect to distribution issues, Ms. Walter outlined some of the differences between the SEC's proposed point-of-sale disclosure to mutual fund investors and the Task Force's 4 recommendation of a two-page disclosure document called the Profile Plus. In particular, she noted that, in addition to disclosure about fees, expenses, revenue sharing and differential compensation, the Task Force recommended the disclosure document explain a fund's investment strategies, risks, and performance history. Also, unlike the SEC's proposal, the Task Force and NASD believe it is preferable to use the Internet to provide this information. In fact, she stated that consumer testing has shown investors strongly prefer getting this information on-line and that NASD hoped that when the SEC acts on its proposal it will accept the Internet as an acceptable method of disclosure. Turning to the topic of investor education, Ms. Walter stated that NASD has created or provides funding for programs on topics such as 401(k)s, 529 plans, and annuities. She also noted that NASD publishes Investor Alerts that briefly inform investors about new products and current frauds and scams. In the fund area, for example, she noted that recent Alerts have addressed NAV transfers, breakpoints, fund share classes, and principal-protected funds. In terms of the future, Ms. Walter noted that "it's not surprising" that fund-related issues -- including those related to hedge funds -- will remain prominent on NASD's agenda. She stated that NASD published a proposal to correct an inconsistency in the rules governing cash sales contests. According to Ms. Walter, NASD also is increasingly concerned about the so-called retailization of hedge fund products and that "the SEC's thresholds for exemption for registration have become, inappropriately, litmus tests for suitability, which is a cornerstone of NASD's regulatory program." Ms. Walter remarked that NASD is considering whether it should adopt a rule setting a higher minimum net worth and income threshold for investors to whom registered representatives can recommend hedge fund shares and perhaps other risky products. She noted that "[w]ealth is not a proxy for sophistication and suitability, but it can be a valuable tool." In closing, Ms. Walter stated that the mutual fund industry, working with the broker- dealer community, can ensure that customers are protected. Remarks by Mr. Villa Mr. Villa, who was the conference's luncheon speaker, discussed a study he recently completed of SEC and criminal proceedings against inside counsel. Not including insider trading cases, Mr. Villa remarked that there were 32 proceedings against inside counsel from 1998 to July 2005. He noted that, before 2002, the cases tended to focus on smaller companies and involve clear misconduct, such as ponzi schemes and sham companies. Cases after 2002, however, have tended to focus on larger companies and involve more subtle issues, such as the timing of income recognition, the omission of adverse information, and the mischaracterization of key events. Mr. Villa stated that in the most recent cases the SEC has focused on the themes in the Sarbanes-Oxley regulations governing lawyers. Mr. Villa drew some overall conclusions about the SEC proceedings against inside lawyers: • Almost all of the cases against inside lawyers by the SEC are against the chief legal officer or the

general counsel of the company. 5 • Inside lawyers that relied on outside counsels' advice are seldom SEC targets. • Many inside lawyers appear to have been the target of enforcement action where it appears their only motive was, in the SEC's view, a misguided attempt to help their corporate employer. • Many of the cases against inside lawyers involve allegedly false and misleading disclosures – more often than not, omissions. • A generalist lawyer serving as general counsel must seek out "good advice or pay the price." Mr. Villa remarked that there are other factors that appear to increase the likelihood of enforcement action, such as an inside lawyer that holds multiple corporate office positions, an inside lawyer with a company that fails or suffers large losses, or an inside lawyer that does not raise troublesome issues with the company's board of directors. Turning to criminal cases against inside lawyers, Mr. Villa remarked that there were approximately 13 criminal prosecutions against inside lawyers from 1996 to July 2005. He provided an overview of these cases, noting that the same basic patterns discussed above are present in the criminal cases. Mr. Villa noted that although the initial charge often involves substantive allegations (e.g., securities fraud) conspiracy, perjury, and obstruction typically become the crime charged. For instance, obstruction often comes from directing employees to lie or mislead investigators. Mr. Villa observed that an "accelerant" to the criminal cases against inside lawyers is the current trend in regulatory proceedings to require a company to waive the attorney-client privilege. Mr. Villa next discussed his "loss prevention conclusions." First, he noted that inside lawyers should be sensitive to the Sarbanes-Oxley regulations because they have drawn the attention of the regulators. Second, he observed that there seems to be an adherence by the regulators to the "corporate ladder" rule and, therefore, inside lawyers should be mindful of their responsibility to bring issues up the corporate ladder. Third, inside lawyers should conduct themselves as if everything will become public. Fourth, inside lawyers should recognize that there is a "hindsight bias." Fifth, inside lawyers should rely on their own sense of right and wrong. Finally, Mr. Villa recommended that inside lawyers have a confidante -- someone who is objective, experienced, and exhibits good judgment – that they can consult on issues of concern. Jane G. Heinrichs Associate Counsel Attachment (in .pdf format) Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (http://members.ici.org) and search for memo 19481, or call the ICI Library at (202) 326-8304 and request the attachment for memo 19481.

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