REGULATORY UPDATE

Editor, Donald F. Moore, Jr.
Bearmoor, LLC
dmoore@bearmoor.com
(719) 748-6025

The Regulatory Update is designed to keep FIRMA members abreast of some of the important issues and events occurring in the trust, investment and financial services industry. It is not meant to be an all-inclusive list of issues and events occurring since the last newsletter update, but rather to provide detailed summaries of some of the most important ones – those the regulatory editor believes should be brought to the reader's attention. While we believe the subjects addressed are accurate, they should not be relied upon or construed as legal advice with regard to any specific matter. In addition, the information contained in this update is based upon the editor's interpretation and are not the opinions (official or unofficial) of the editor's employers.

REGULATORY UPDATE

Editor's Note: *Welcome to the New Year. As you know, many unique and new challenges will present themselves to the financial industry in 2008. Status quo can no longer be the business model for the fiduciary and investment management industry. While other areas of the financial industry may be retrenching or even posting losses, the fiduciary and investment management arena will continue to challenged for both asset and revenue growth; perhaps increasing their risk profile. In this issue I thought it would be appropriate to outline various speeches that have been given by regulatory agencies. These will assist in shining a light on areas where regulatory concern exists. SEC Gene Gohlke addresses issues surrounding the mutual funds, FRB Governor Mishkin discussing risks associated with the market and investing, and EBSA Assistant Secretary Bradford Campbell discusses issues surround retirement fees and their disclosure. As always, should you have specific items you would like to be presented/discussed in the Regulatory Update, please send your requests to the attention of the FIRMA Forum Editor, or myself.*

SEC: Speech by SEC Staff - "If I Were a Director of a Fund Investing in Derivatives – Key Areas of Risk on Which I Would Focus"

Background

On November 8, 2007, at the Mutual Fund Directors Forum Program Gene Gohlke, Associate Director, Office of Compliance Inspection and Examinations, U.S. Securities and Exchange Commission, provided information regarding areas of risk that should be known and understood by those responsible for the oversight of mutual funds. Below are the salient points from his speech.

Introduction

As you are working your way through the agenda of this program, which is focused on mutual funds use of derivatives, you are learning that the scope of what constitutes a derivative instrument is broad and that derivatives range from the rather mundane convertible bond to the very complex, structured product known as a collateralized debt obligation and, of course, many things in-between. Just as the range of derivative instruments is broad so are the risks assumed by investors in these instruments. There are market, liquidity, leverage, counterparty, valuation, legal and structure risk to name only a few.

As fund directors you are responsible generally for overseeing your fund's investments to make sure that the risks assumed by the fund are consistent with the risk disclosures the fund has made to its shareholders. In addition, you are specifically responsible for establishing fair value procedures the fund is to use in pricing its derivative (and other) positions for which there are no readily available market quotations. You are also responsible for approving codes of ethics of both the fund and its investment adviser to ensure that the ethical principals established are appropriate in light of the environment in which the fund and adviser operate. Finally, you are responsible for determining that all of the fund's compliance policies and procedures and those of its service providers are reasonably designed to prevent violations of the securities laws.

In my time with you today, I want to talk about certain aspects of a fund's involvement with derivative instruments that fund directors should pay particular attention to. The way I want to approach this presentation is to assume that I was a director of a fund investing in derivatives and then identify those areas of risk that I as a fund director would most want to focus on. In the text below, I focus on 12 areas of risk that I think are most important. Within each of these areas, I start by stating a question I would ask and then include a few related thoughts and comments designed to highlight specific activities, risks and compliance tests that I think are important. (Note that while the discussion below is framed in the context of a fund investing in derivatives, these same questions appear to be relevant as regards risks in most funds). As an actual fund director, I would expect to obtain answers to these questions from various of the fund's service providers, its CCO and legal counsel and then based on those answers, determine if the fund's exposure to the risks associated with its investments in derivatives is appropriate in light of fund shareholder's expectations.

Important Areas of Risk

1. **Does the fund's adviser have the intellectual and financial resources to be a knowledgeable, nimble participant in the derivatives in which the fund invests?**
   - How do the group's resources and abilities compare to those of the counterparties the fund will encounter in the marketplace?
   - Can the fund's adviser access and analyze all relevant information to be able to fully understand the probable risks and returns associated with a position; in particular, I as a director would be interested in the following:
     - The specific derivative instruments in which the fund will be investing, the way in which each instrument will be used in achieving the fund's

    investment objectives and the significant risks associated with each instrument;
  ◊ The information needed to make informed investment decisions and the sources of such information;
  ◊ The means by which sources of information will be compensated;
  ◊ How and by whom will that information be used;
  ◊ Contingency plans to obtain information if the primary sources become unavailable;
- Does the fund's adviser have the necessary human and technological resources to make informed investment decisions and implement those decisions on the best possible terms and conditions;
- Does the fund's adviser have the depth of knowledge and experience regarding each investment strategy employing derivatives so as to be able to effectively oversee and supervise the primary decision-makers and form the basis for backup and continuity of investment decision-making?

2. **Do we investigate before we leap into an investment?**
   - Does the group use a well thought out process, often called a due diligence or new products process or committee, through which every proposed investment in a different type of derivative instrument is subject to vetting by knowledgeable persons from all operational areas (not just those operated by the adviser);
   - Is the objective of this due diligence process to fully probe, analyze and evaluate all features associated with a proposed investment to identify the risks and operational requirements that would come with such an investment and determine if the fund's service providers that will be impacted have or would be able to create the necessary infrastructure to timely and appropriately process, account for, custody, control and report on the new instrument;
   - Can investments in new instruments only be made after all associated risks have been identified and a determination is made that the infrastructure used by the fund's service providers will effectively handle the attributes of these instruments;
   - Does this due diligence process bring together in a deliberative format all disciplines or operational areas that may be impacted by the investment such as:
     ◊ Research
     ◊ Portfolio management
     ◊ Risk management
     ◊ Trading
     ◊ Clearance and settlement
     ◊ Code of ethics and non-public information management
     ◊ Custody/safekeeping
     ◊ Recordkeeping
     ◊ Pricing and valuation
     ◊ Tax
     ◊ Legal/contractual
     ◊ Disclosure and investor reporting
     ◊ Performance calculations
     ◊ Compliance

3. **Is there an effective investment risk management function that has the capacity to regularly identify, measure, evaluate and manage the fund's ongoing risk exposure?**
   - Does the fund's adviser maintain an appropriately staffed function that is independent of portfolio management and which is responsible for continuously measuring the extent of the fund's risk exposure using various tools such as value at risk, stress and scenario testing;
   - Is the risk information used to effectively manage the fund's exposure to risk to make sure the extent of risks taken remain within boundaries established in the fund's disclosures to its shareholders?

4. **Are the investment and operational risks associated with the fund's investments in derivatives fully and fairly disclosed to the fund's shareholders in its prospectus/statement of additional information and in periodic reports to fund shareholders?**
   As a director, I would want to understand the process that is used to ensure that the ongoing level of risk to which the fund is exposed from its investments in derivatives is being fully and fairly described and illustrated in various disclosure documents provided to fund shareholders and that the language used to describe such risks is likely to be understood by the average investor in the fund.

5. **Are all of the fund's service providers effectively preventing the inappropriate use of non-public information that may be received in connection with its investment in derivatives?**
   - Are the adviser's and fund's (and to the extent necessary, other fund service providers) code of ethics and the related policies and procedures established to prevent inappropriate decision-making using non-public information sufficiently broad, proactive and effective to monitor and manage information flows associated with the fund's investment in derivatives;
   - Do codes of ethics fully address relevant compliance

with the federal securities laws by supervised persons in light of the possible additional sources of information and the types of information that will be needed to be an informed participant in the derivatives markets in which the fund is engaged;
- Does testing of access persons trading in their personal accounts reflect ways in which derivatives can be used to effect long and short positions in issuers to take advantage of advance knowledge of trading by the fund or announcements by issuers;
- Do policies and procedures established and implemented as required by Section 204A of the Advisers Act to prevent the inappropriate use of non-public information reflect effectively both traditional and non-traditional sources of information that may come into the possession of access persons.

6. **Is the process used to measure and monitor liquidity/illiquidity of the fund's portfolio effective to ensure that the liquidity available is consistent with ongoing liquidity needs as measured by fund shareholders' purchase and redemption activity?**
    - Have the fund's service providers established and implemented a working definition of liquidity so everyone responsible knows what is to be measured and is using the same benchmark;
    - Have policies been established regarding how frequently liquidity measures will be calculated and the situation evaluated;
    - Have liquidity trigger points been established, using metrics such as various percentages of the portfolio in illiquid positions in relation to net redemption activity, that would require a review of the situation and perhaps changes in the portfolio to increase the amount of liquid assets available?

7. **Is the process for defining, measuring and monitoring embedded or economic leverage associated with any of the fund's positions in derivatives effective to ensure that the fund's aggregate exposure to leverage is consistent with risk disclosures made to fund shareholders and statutory limitations?**

    - Have the fund's service providers established working definitions of economic leverage for the various derivatives in which the fund invests;
    - Is the amount of leverage to which the fund is exposed and the related risks measured regularly and are these metrics evaluated for consistency with disclosures made to fund shareholders and are remedial actions taken as appropriate;
    - Is economic (as well as any balance sheet) leverage assumed by the fund in its derivative positions being managed appropriately through the use of asset earmarking/segregated accounts to ensure the fund's compliance with statutory limitations?

8. **Are the values for the fund's positions used in calculating its NAV reasonable in light of current market conditions?**
    - Do the processes used to value the fund's derivative positions, including the use of the fair value procedures adopted by the Board, provide substantial assurance that the value used each day for each derivative position held by the fund will reflect an amount the fund could reasonably expect to realize on that position in a closing transaction with a knowledgeable counterparty at the time daily NAV's are being determined;
    - With the above stated goal of the fund's valuation process in mind, as a director I would want information about such specific factors as:
        - ◊ Source(s) of daily pricing information for derivative positions needed to calculate NAVs;
        - ◊ Tests applied to prices obtained from pricing services, dealer quotes and outputs of models to ensure that such prices are appropriate
        - ◊ If pricing information is obtained from a pricing service and the values are anything other than a pass-through of closing market prices, familiarity with their process for determining values given to the fund
        - ◊ If internal models are used to create prices, the factors and assumptions used by such models and the periodic testing done to evaluate the appropriateness of the model inputs as well as the algorithms used in the model
        - ◊ Secondary sources of pricing information
    - Knowing that the Board is responsible for fair valuation procedures and that derivatives may require fair valuing, the Board will need to obtain detailed information about the factors affecting the value of each of the different types of derivatives the fund may hold and how those factors can be used to estimate fair values;
    - I would also want to make sure that there was a regular flow of information coming to appropriate decision-makers regarding how the fund's fair value procedures are being used in practice and how accurate the fair values used are in estimating market values. In regard to accuracy of fair values, I would expect that a number of appropriate tests would be used to gauge such accuracy. The following are among the tests that could be used:

- ◊ Comparing today's prices for each instrument to yesterday's price
- ◊ Change in today's price for an instrument from yesterday's price compared to change from yesterday to today in a relevant index or for comparable instruments
- ◊ Identifying instruments whose prices have not changed over a period of a week or so, especially in times of volatile markets
- ◊ Comparing change in fund's NAV from one day to the next to changes in one or more benchmarks to which the fund compares its performance or that reflect activity in the market sectors in which the fund is active
- ◊ Volatility in a fund's NAV from day to day and over longer periods in relation to volatility in observable market factors and in comparison to internal estimates and projections
- ◊ Periodically closing out one or more positions that have been fair valued for an extended period, using transactions that are otherwise consistent with investment decisions made for the fund's portfolio, to test the price realized upon close out to carrying value of the position in days leading up to the closing transaction
- ◊ Compare all prices realized in closing transactions with arms length counterparties with previous day's carrying values and analyze differences for any pattern of skewing that suggests systematic over our under valuation
- ◊ Compare prices fund uses to prices for the same instruments used by a prime broker or a counter-party for a position
- ◊ Analyze trade blotter to look for a pattern of transactions with one or more BDs that are sources of quotes used to price fund positions (sham transactions) that suggests an attempt by fund insiders to manage the valuations used by the fund

- In addition to forensic testing, a number of other compliance procedures are important to ensure prices used accurately reflect current market factors. In particular I would want information regarding the controls used to manage overrides of prices obtained from pricing services, broker quotes or output of fair value models and specific information regarding any pattern of overrides for specific derivatives held by the fund;
- Finally, I would want to understand the process used by the relevant service provider to properly classify each derivative position held by the fund on a financial reporting date into one of the 3 valuation tiers established by FASB 157 and whether written explanations of changes in Tier 3 exposures are accurate and understandable to the average reader?

9. **Are operating processes used by the entities providing back office services for the fund's derivative positions robust, produce timely results and have sufficient depth to handle unexpected events and spikes in activity?**
   - Have all back office service providers such as administrators, pricing agents, and custodians established and implemented effective policies and procedures that address every aspect of the services they provide to the fund;
   - Do these service providers use relevant tests to measure the level and quality of their services and are the results of these tests available to the fund's CCO for oversight and monitoring purposes;
   - Have these service providers established effective processes for anticipating the occurrence of disruptive events and established backup plans and alternatives for handling the impact of these disruptive events.

10. **Are the compliance procedures of the fund and its service providers effectively managing all material compliance risks regarding the fund's investments in derivatives and include a menu of testing for compliance in critically important areas?**
    As a fund director and knowing that the Board is responsible for reviewing and approving the compliance policies and procedures of its service providers:
    - I would want to make sure the board focuses specific attention on those policies and procedures that are used to control critical activities regarding the fund's investments in derivatives such as information flows, liquidity, leverage and valuation;
    - I would devote specific attention to the forensic tests used to make sure such policies and procedures have been implemented effectively and that appropriate follow-up and corrective actions are taken regarding shortfalls and compliance breaches identified in exception and other compliance-related reports.

11. **What role does the fund's CCO have in monitoring the fund's exposure to derivatives and how can the CCO be used most effectively as the “eyes and ears” of the Board in regard to overseeing the risks associated with the fund's investments in derivatives and ensuring that such risks are consistent with disclosures to and expectations of the fund's shareholders?**
    As a fund director I would engage in a continuing dialogue with the fund's CCO regarding how the CCO, giving due

regard for all of the other responsibilities that come with the position, can assist the Board in effectively monitoring the fund's investments in derivatives, including the risks it is taking, the returns being earned for assuming those risks and how these risks and returns can most effectively be communicated to fund shareholders.

12. **What information regarding the fund's exposure to derivatives' risks and returns will the Board get on a regular basis and what information should it get on an exception basis to keep it informed regarding the fund's investment in derivatives?**
    - As a fund director, I do not want to micro-manage the fund's investments in derivatives. However, recognizing that such investments can create a significant risk exposure for fund shareholders I would want either to receive or, at least, have access to reports prepared for other persons that would give the Board the information it needs to effectively oversee the fund's investments in derivatives in a manner that is likely to be consistent with the expectations of fund shareholders.
    - Examples of information for a fund investing in derivatives I would want to have access to on a regular basis (weekly /monthly), perhaps in the form of "dashboard reports" delivered in paper format or available in an on-line space on the group's internal web site, include the following:
        - Average daily gross and net assets
        - Average of daily assets in illiquid positions as a percentage of daily net assets
        - Average of daily assets earmarked or in segregated accounts for Section 18 purposes as a percentage of daily net assets
        - Average daily net sales/redemptions as a percentage of net assets
        - Number of days during period in which the change from the previous day's NAV per share exceeded the per share value at risk for that period
        - Total return for the period compared to total return for the period on a relevant market index
        - Average daily total amount of assets for which fair value was used in calculating NAV as a percentage of average daily gross assets
    - In addition to a regular flow of information as described above, I would have standing instructions with the fund's CCO and its service providers that I will want to be informed regarding unusual or exceptional matters that may arise regarding the fund's investments in derivatives. Examples of such matters could include, failure of a counterparty to a position held by the fund to perform as required; significant operational or control breach at a service provider; pricing model unraveling requiring a change in fair value procedures; and a sudden, material change in a measure that is otherwise reported to the Board on a periodic basis.

Conclusion

I appreciate that many of the questions I've thrown out here today raise complex and difficult issues; often, they'll require different answers in different situations. But as a director, I would want to recognize that the potential benefits of investing in derivatives may quickly dissolve into disaster. I would want to understand those risks, be assured that the fund's service providers understood those risks, and have seen that appropriate processes and systems were put in place to manage, monitor, and mitigate those risks. Only then would I feel comfortable in exposing the fund and its shareholders to derivatives.

FRB – Speech by Governor Frederic S. Mishkin at the Risk USA 2007 Conference in New York on November 5, 2007.

Background

On November 5, 2007, Federal Reserve Board Governor Frederic S. Mishkin provided a speech to the attendees of the Risk US Conference in New York. In his speech Governor Mishkin discussed financial instability and monetary policy, including various risks associated with the current environment. While the majority of his comments discuss the current situation in the mortgage industry, the risks discussed must be considered when making any investment decision for fiduciary accounts. Below are the comments from Governor Mishkin's speech.

Information

Financial Instability and Monetary Policy: After operating for years under very favorable conditions and ample liquidity, financial markets came under stress last summer and have not yet fully recovered. This ongoing episode has reminded investors and policymakers alike that financial instability, if allowed to develop fully, could have severely negative conse-

quences not only for the functioning of financial markets but also, importantly, for the macroeconomic prospects of our country as well as others. It is this connection with the real side of the economy that makes financial stability a central concern for me and my colleagues at the Federal Reserve and at other central banks around the world.

Policymakers, particularly those in a central bank, are faced with the questions of what they should do to prevent financial instability and what their responses should be when financial instability threatens to compromise economic performance. To start answering these questions, we must first understand the nature of financial instability and how it might affect the macroeconomy.

The Nature of Financial Instability: The financial system performs the function of efficiently channeling funds to individuals or corporations with worthy investment opportunities. If shocks interfere with the information flows that are necessary for a smooth functioning of the financial system, the system can be disrupted and financial instability can arise. By disrupting the flow of credit, financial instability, in turn, becomes a threat to economic performance.

The information that is necessary for the efficient functioning of the financial system is by its nature asymmetric: Often, one party to a financial contract (typically the lender) has much less accurate information about the outcome of an investment than does the other party (typically the borrower). As I have explained in more detail in a recent speech, such asymmetry leads to two prominent difficulties for the functioning of the financial system: adverse selection and moral hazard.

Adverse selection arises when investments that are most likely to produce an undesirable (*adverse*) outcome are the most likely to be financed (*selected*). For example, investors who intend to take on large amounts of risk are the most likely to be willing to seek out loans because they know that they are unlikely to pay them back. Moral hazard arises because a borrower has incentives to invest in high-risk projects, in which the borrower does well if the project succeeds but the lender bears most of the loss if the project fails.

Historically, banking institutions and other financial intermediaries have played a major role in reducing the asymmetry of information because they are well placed to collect information from borrowers and to engage in long-term relationships with clients. In more recent times, improved transparency and financial innovation – in the form of new financial products as well as new types of institutions that have become active in markets – have also contributed to the efficient flow of information across the system. The continuity of this flow helps keep adverse selection and moral hazard in check and is crucial to the process of *price discovery* – that is, the ability of markets to collect information and properly evaluate the worth of financial assets.

During periods of financial distress, information flows may be disrupted, and price discovery may be impaired. The high risk spreads and reluctance to purchase assets that are characteristic of such episodes are natural responses to the increased uncertainty resulting from the disruption of information Two types of risks are particularly important for understanding financial instability. The first is what I will refer to as valuation risk: The market, realizing the complexity of a security or the opaqueness of its underlying creditworthiness, finds it has trouble assessing the value of the security. For example, this sort of risk has been central to the repricing of many structured-credit products during the turmoil of the past few months, when investors have struggled to understand how potential losses in subprime mortgages might filter through the layers of complexity that such products entail.

The second type of risk that I consider central to the understanding of financial stability is what I call *macroeconomic risk* – that is, an increase in the probability that a financial disruption will cause significant deterioration in the real economy. Because economic downturns typically result in even greater uncertainty about asset values, such episodes may involve an adverse feedback loop whereby financial disruptions cause investment and consumer spending to decline, which, in turn, causes economic activity to contract. Such contraction then increases uncertainty about the value of assets, and, as a result, the financial disruption worsens. In turn, this development causes economic activity to contract further in a perverse cycle.

Deterioration of balance sheets during a recession can also intensify problems of adverse selection and moral hazard because it removes an important channel through which information asymmetries are mitigated – the use of collateral. If a borrower defaults on a loan backed by collateral, the effects of the adverse selection problem are less severe because the lender can take title to the collateral and thus make up for the loss. In addition, the threat of losing the collateral gives the borrower more incentives not to take unmanageable risks that might ultimately lead to a default, and it thus reduces the moral hazard problem. These mechanisms work only as long as the collateral is of sufficient quality; during macroeconomic downturns, the value of collateral may fall, problems of adverse selection and moral hazard again become central, and lenders become much less willing to lend. Again, these events can result in an adverse feedback loop.

Shocks of various natures can interfere with the information

flow in financial markets and thereby precipitate financial instability through valuation and macroeconomic risk. Historical examples of such shocks include higher interest rates, problems in the banking sector, increases in uncertainty, and asset market effects on balance sheets. Of those, the last two appear to have been especially prominent in the ongoing episode of financial instability.

Interpreting the Recent Episode of Financial Instability: One could argue that the valuation of financial products backed by mortgages and corporate loans has always been uncertain, as the ability of borrowers to repay their debt ultimately depends on the performance of the economy. Yet, especially in very recent years, investors appeared to be less concerned about macroeconomic uncertainty or about the attendant problems of adverse selection and moral hazard inherent in asset-backed products. Thus, abundant credit flowed cheaply to borrowers regardless of the risks involved.

However, beginning in the spring and continuing to the present time, a considerable amount of uncertainty has surrounded markets' valuations of many structured-finance products – part of the flurry of innovative financial instruments that have become popular among market participants in recent years. Generally, increased uncertainty in financial markets makes it harder for lenders to screen good credit risks from bad and ultimately makes information more asymmetric, thereby possibly exacerbating the adverse selection problem. Consequently, lenders may become less willing to lend, and that reluctance may lead to a decline in investment and aggregate activity. During the recent turmoil, the opaqueness of structured-credit products contributed to market uncertainty until investors in those products (who were ultimately lenders to households and corporations) withdrew from the market and left borrowers without an important source of credit.

In the housing market, where price appreciation has slowed or even turned to depreciation in many areas, delinquencies and defaults have risen of late, especially in the variable-rate subprime sector. In addition, the decline in house prices has induced a clear deterioration in the collateral behind home mortgages. As a consequence, lenders have responded by tightening standards and terms and, ultimately, by reducing credit.

Similarly, the collateral offered by many financial institutions to back the borrowing they needed to finance their operations also became questionable. As a result, these institutions found credit much more difficult to obtain, or much more costly, or both. Funding difficulties for financial institutions clearly have the potential to turn into tighter credit conditions for households and nonfinancial businesses alike.

The Role of the Federal Reserve: Against this backdrop, what role should the Federal Reserve perform to pursue its objectives? To answer this question, we must first understand exactly what those objectives are. The Federal Reserve was created by the Congress in 1913 to provide an effective backstop against the recurring episodes of financial panic that were relatively frequent at the time. Even so, the interest of the Congress was not financial stability per se. Rather, the Congress was concerned that financial panics were often followed by sharp contractions in economic activity, and it recognized that a stabilization of the financial system would lead to a stabilization of the whole U.S. economy.

Originally, the preamble to the Federal Reserve Act of 1913 stated that the Federal Reserve System was created "to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." Later, in 1977, the Congress amended the act to introduce macroeconomic objectives explicitly. Accordingly, it stated that "the Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Because long-term interest rates can remain low only in a stable macroeconomic environment, these goals are often referred to as the dual mandate – that is, the Federal Reserve seeks to promote the two coequal objectives of maximum employment and price stability. But although the main interests of the Federal Reserve are macroeconomic in nature, well-functioning financial markets are ancillary to good economic performance. Conversely, financial instability can compromise economic growth and price stability. Because of this intimate connection with economic performance, the Federal Reserve has a clear interest in promoting the stability of financial markets.

The Federal Reserve has various tools at its disposal to promote financial stability. In a speech two weeks ago, I discussed its role as a liquidity provider. Today, I will instead focus on how monetary policy can be used as an effective instrument to keep markets stable and to counter the macroeconomic effects of a system that has become unstable.

As a general principle, a sound monetary policy is one that will foster the objectives of price stability and maximum sustainable employment. Such a policy can make financial instability less likely. In my view, the reason that this is so resides once again in the informational asymmetries that pervade our financial system. For example, in an economy that experiences severe swings in output growth, lenders will be more reluctant

to lend and will demand higher interest rates because of the higher risks that borrowers will default. But this situation is likely to exacerbate the adverse selection problem, as only riskier borrowers will be willing to take out loans at higher interest rates. Similarly, in an environment of high inflation, lenders will not be willing to lend for long periods. Debt contracts will then tend to have short maturities, thereby increasing the system's exposure to cash flow and liquidity problems.

Financial instability, however, can arise even if macroeconomic fundamentals are good and monetary policy is sound, simply because of shocks that are unforeseen by policymakers or that cannot be prevented from occurring. In this case, monetary policy can also be useful because it can help forestall the negative macroeconomic consequences of financial instability. An easier monetary policy provides a direct stimulus to the economy, as it generally leads to lower interest rates across the term structure. Lower rates reduce the cost of capital for borrowers and therefore encourage investment. They also generally boost asset prices, thereby increasing wealth and encouraging consumer spending.

Researchers have also identified other channels through which monetary policy is effective. One important one is the credit channel. The credit-channel view holds that monetary policy has additional effects because interest rate decisions influence the cost and availability of credit by more than would be implied by the associated movement in risk-free interest rates (Bernanke and Gertler, 1995; Bernanke, 2007a).For example, an easier monetary policy strengthens the balance sheets of borrowers. This stronger financial position, in turn, enables the borrower to reduce its potential conflict of interest with the lender, either because the borrower is able to self-finance a greater share of its investment projects, or because it can offer more or better collateral to guarantee its liabilities. As a result, firms and households will find it easier to increase their spending.

In addition to having beneficial macroeconomic effects, monetary policy can also help directly restore stability in financial markets after a period of financial instability. As we have seen, financial instability can basically be viewed as a disruption of information; therefore, its resolution requires a restoration of information flows. Monetary policy can contribute to this process by minimizing market uncertainty.

I noted a moment ago that periods of financial instability are characterized by valuation risk and macroeconomic risk. Monetary policy cannot have much influence on the former, but it can certainly address the latter – macroeconomic risk. By cutting interest rates to offset the negative effects of financial turmoil on aggregate economic activity, monetary policy can reduce the likelihood that a financial disruption might set off an adverse feedback loop. The resulting reduction in uncertainty can then make it easier for the markets to collect the information that enables price discovery and to hasten the return to normal market functioning.

To achieve this result most effectively, monetary policy needs to be timely, decisive, and flexible. Quick action is important for a central bank once it realizes that an episode of financial instability has the potential to set off a perverse sequence of events that pose a threat to its core objectives. Waiting too long to ease policy in such a situation would only risk a further deterioration in macroeconomic conditions and thus would arguably only increase the amount of easing that would eventually be needed.

Decisive action is also important. In circumstances when the risk of particularly bad economic outcomes is very real, a central bank may want to buy some insurance and, so to speak, "get ahead of the curve" – that is, ease policy more than it otherwise would have simply on the basis of its modal economic outlook. However, because monetary policy makers can never be certain of the amount of policy easing that is needed to forestall the adverse effects of disruptions in financial markets, decisive policy actions may, from time to time, go too far and thus produce unwelcome inflationary pressures. That's why I said that flexibility is also an important characteristic of monetary policy during a time of financial turmoil. If, in their quest to reduce macroeconomic risk, policymakers overshoot and ease policy too much, they need to be willing to expeditiously remove at least part of that ease before inflationary pressures become a threat.

Some may see a monetary policy that actively addresses episodes of financial instability along the lines that I have just described as promoting excessive risk-taking and thus increasing the probability of future crises. In other words, such a policy might appear to create some moral hazard problems of its own. I question, however, the validity of this view. As I pointed out earlier, the Federal Reserve has a mandate from the Congress to promote maximum employment and stable prices, and it will choose its monetary policy actions so as to best meet that mandate. That said, as pointed out recently by Chairman Bernanke, it is not the responsibility of the Federal Reserve – nor would it be appropriate – to protect lenders and investors from the consequences of their financial decisions (Bernanke, 2007b). Indeed, the Federal Reserve can hardly insulate investors from risk, even if it wished to do so. And the fact that investors who misjudged the risks they were taking lost money over the past few months as well as during most other episodes of financial turmoil, independently of the monetary policy actions taken by the Federal Reserve, certainly corroborates this argument. The point is that, although the Federal Reserve can and should offset macroeconomic risk with monetary pol-

REGULATORY UPDATE

icy decisions, investors remain responsible for dealing with valuation risk. Indeed, monetary policy is and should be powerless in that respect. It is solely the responsibility of market participants to do the hard work of price discovery and to ascertain and manage the risks involved in their investments.

The Federal Reserve's Recent Monetary Policy Decisions: What I just said should serve as a framework for understanding the recent decisions of the Federal Reserve to ease policy, first by 50 basis points on September 18 and then by another 25 basis points last week. The first action was larger than markets expected at the time – indeed, quotes from the federal funds futures market as well as survey data indicated that most investors had anticipated a cut of only 25 basis points in the target federal funds rate ahead of that meeting. As reported in the minutes, the Federal Open Market Committee (FOMC) judged that a policy easing of 50 basis points was appropriate to help offset the effects of tighter financial conditions on the economic outlook. Had the FOMC not eased policy, it would have faced a risk that the tightening of credit conditions and an intensifying housing correction would lead to significant broader weakness in output and employment. In addition, it would have faced the possibility that the impaired functioning of financial markets would persist for some time or worsen, which would create an adverse feedback loop not dissimilar to what I earlier called macroeconomic risk. The cut of 50 basis points at that meeting was the most prudent action from a macroeconomic standpoint, even given the Federal Reserve's objective of price stability. Indeed, with economic growth likely to run below its potential for a while and with incoming inflation data to the favorable side, the easing of policy, even if substantial, seemed unlikely to affect adversely the outlook for inflation.

It should be clear at this point that the FOMC's decision was made purely on macroeconomic grounds – that is, policy was eased solely to offset macroeconomic risk. The changed policy stance would not have interfered with the ongoing adjustments in the pricing of financial instruments – that is, the policy action, even if larger than investors had expected, would not have had any effects on valuation risk.

The response of the markets to the easing of monetary policy in September was encouraging. Financial market functioning improved after the decision was announced, an outcome that partially allayed the risks of a coming credit crunch and thus suggested that macroeconomic risk may have been reduced. Still, conditions in several markets remained strained. In part, those tensions certainly reflected the fact that valuation risk was still substantial and would not be reduced quickly. Indeed, the process of price discovery is ongoing, and it will likely be some time before it is completed.

At the FOMC meeting last week, the federal funds rate target was lowered by another 25 basis points. Our economy grew at a solid pace in the third quarter and was boosted importantly by personal consumption and business expenditures, an indication of considerable underlying strength in spending before the recent financial turbulence. However, the pace of economic expansion is expected to slow in the near term, largely because of the intensification of the housing correction. The combined 75 basis points of policy easing put in place at the past two meetings should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and should help promote moderate growth over time.

Going into the meeting, I was comforted by the lack of direct evidence to-date of serious spillovers of the housing weakness and of tighter credit conditions on the broader economy. But with an unchanged policy interest rate, I saw downside risks to the outlook for growth. I was mindful, in particular, of the risk that still-fragile financial markets could be particularly exposed to potential adverse news on the housing situation, or on the macroeconomy more generally, and that renewed strains in financial markets could feed back adversely on economic performance. My vote to ease policy at the meeting was motivated by my wish to reduce those risks. The FOMC perhaps could have waited for more clarity and left policy unchanged last week, but I believe that the potential costs of inaction outweighed the benefits, especially because, should the easing eventually appear to have been unnecessary, it could be removed.

In voting to ease policy, I carefully considered the effect of that decision on our other objective – price stability. I reasoned that the anticipated softening of economic growth and perhaps the emergence of some slack in the labor market might reduce those pressures, and I judged that a cut of 25 basis points in the target federal funds rate would not materially alter that modal outlook. However, I recognized the risk that, even if readings on core inflation have improved modestly this year, recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation. Consequently, in considering appropriate future adjustments to policy, I will monitor inflation developments carefully.

Overall, I think that the cumulative policy easing the FOMC put in place at its past two meetings reduced significantly the downside risks to growth so that those risks are now balanced by the upside risks to inflation. In these circumstances, I will want to carefully assess incoming data and gauge the effects of financial and other developments on economic prospects before considering further policy action. As always, my colleagues on the FOMC and I will act to foster our dual objectives of price stability and sustainable economic growth.

Conclusions

As I have argued here, under the mandate it has been given by the Congress, the Federal Reserve has a responsibility to take monetary policy actions to minimize the damage that financial instability can do to the economy. I hope I was clear in communicating to you that policies to achieve this goal are designed to help Main Street and not to bail out Wall Street. Pursuing such policies does help financial markets recover from episodes of financial instability, and so it can help lift asset prices. But this does not mean that market participants who have been overly optimistic about their assessment of risk don't pay a high price for their mistakes. They have, and that is exactly what should happen in a well-functioning economy – which, after all, is what the Federal Reserve is seeking to promote.

EBSA: Testimony before House Ways and Means Committee on 401(k) Fee Disclosure

Background

On October 30, 2007, Bradford P. Campbell, Assistant Secretary of Labor for employee benefits security, testified before the U.S. House of Representatives Ways and Means Committee in support of improved disclosure of 401(k) fees and expenses.

Campbell's testimony focused on the Labor Department's three regulatory initiatives for expanding disclosure requirements to provide participants, plan fiduciaries and the public with better information about plan fees and expenses. His testimony described the department's significant progress to date in the regulatory arena and highlighted its enforcement activities, which have resulted in more than $64 million in monetary results from 401(k) investigations.

Campbell told the committee that the Labor Department has the authority under current law to require additional disclosure. Campbell said that the department expects to issue final regulations addressing disclosures to the public, and will be proposing within several months regulations addressing specific and comprehensive disclosures to plan fiduciaries by service providers. Furthermore, the department expects to issue a proposed regulation requiring disclosure by plans to participants this winter. Below are comments from his testimony.

Information

Introductory Remarks: Good morning Chairman Rangel, Ranking Member McCrery, and Members of the Committee. Thank you for inviting me to discuss plan fees, the Department of Labor's role in overseeing plan fees, and proposals to increase transparency and disclosure of plan fee and expense information. I am Bradford Campbell, the Assistant Secretary of Labor for the Employee Benefits Security Administration (EBSA). I am proud to be here today representing the Department of Labor and EBSA. Our mission is to protect the security of retirement, health and other employee benefits for America's workers, retirees and their families, and to support the growth of our private benefits system.

Ensuring the security of retirement benefits is a core mission of EBSA, and one of this Administration's highest priorities. Excessive fees can undermine retirement security by reducing the accumulation of assets. It is therefore critical that plan participants directing the investment of their contributions, and plan fiduciaries charged with the responsibility of prudently selecting service providers and paying only reasonable fees and expenses, have the information they need to make appropriate decisions.

That is why the Department began a series of regulatory initiatives in 2006 to expand disclosure requirements in three distinct areas:

- Disclosures by plans to participants to assist in making investment decisions;
- Disclosures by service providers to plan fiduciaries to assist in assessing the reasonableness of provider compensation and potential conflicts of interest; and
- More efficient, expanded fee and compensation disclosures to the government and the public through a substantially revised, electronically filed Form 5500 Annual Report.

Each of these projects addresses different disclosure needs, and our regulations will be tailored to ensure that appropriate disclosures are made in a cost effective manner. For example, participants are unlikely to find useful extensive disclosure documents written in "legalese"—instead, it appears from comments we received thus far that participants want concise and readily understandable comparative information about plan costs and their investment options. By contrast, plan fiduciaries want detailed disclosures in order to properly carry out their duties under the law, enabling them to understand the nature of the services being provided, all fees and expenses received for the services, any conflicts of interest on the part of the service provider, and any indirect compensation providers may receive in connection with the plan's business.

REGULATORY UPDATE

We have made significant progress on these projects. We will be issuing a final regulation requiring additional public disclosure of fee and expense information on the Form 5500 within the next few weeks. In the next several months we will publish a proposed regulation requiring specific and comprehensive disclosures to plan fiduciaries by service providers. We also concluded a Request for Information seeking the views of the interested public on issues surrounding disclosures to participants. We are currently evaluating the comments received from consumer groups, plan sponsors, service providers and others as we develop a proposed regulation.

The Employee Retirement Income Security Act of 1974 (ERISA) provides the Secretary with broad regulatory authority, enabling the Department to pursue these comprehensive disclosure initiatives without need for a statutory amendment. The regulatory process currently underway ensures that all voices and points of view will be heard and provides an effective means of resolving the many complex and technical issues presented. I hope that as Congress considers this issue, it recognizes the Department's existing statutory authority and takes no action that could disrupt our current efforts to provide these important disclosures to workers. My testimony today will discuss in more detail the Department's activities related to plan fees. Also, I will describe the Department's regulatory and enforcement initiatives focused on improving the transparency of fee and expense information for both plan fiduciaries and participants.

Overview: EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of ERISA. EBSA oversees approximately 683,000 private pension plans, including 419,000 participant-directed individual account plans such as 401(k) plans, and millions of private health and welfare plans that are subject to ERISA. Participant-directed individual account plans under our jurisdiction hold over $2.2 trillion in assets and cover more than 44.4 million active participants. Since 401(k)-type plans began to proliferate in the early 1980s, the number of employees investing through these types of plans has grown dramatically. The number of active participants has risen almost 500 percent since 1984 and has increased by 11.4 percent since 2000.

EBSA employs a comprehensive, integrated approach encompassing programs for enforcement, compliance assistance, interpretive guidance, legislation, and research to protect and advance the retirement security of our nation's workers and retirees.

Title I of ERISA establishes standards of fiduciary conduct for persons who are responsible for the administration and management of benefit plans. It also establishes standards for the reporting of plan related financial and benefit information to the Department, the IRS and the PBGC, and the disclosure of essential plan related information to participants and beneficiaries.

The Fiduciary's Role: ERISA requires plan fiduciaries to discharge their duties solely in the interest of plan participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying reasonable expenses of plan administration. In discharging their duties, fiduciaries must act prudently and in accordance with the documents governing the plan. If a fiduciary's conduct fails to meet ERISA's standards, the fiduciary is personally liable for plan losses attributable to such failure.

ERISA protects participants and beneficiaries, as well as plan sponsors, by holding plan fiduciaries accountable for prudently selecting plan investments and service providers. In carrying out this responsibility, plan fiduciaries must take into account relevant information relating to the plan, the investments available under the plan, and the service provider, and are specifically obligated to consider fees and expenses.

ERISA prohibits the payment of fees to service providers unless the services are necessary and provided pursuant to a reasonable contract, and the plan pays no more than reasonable compensation. Thus, plan fiduciaries must ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of services provided. Plan fiduciaries must also be able to assess whether revenue sharing or other indirect compensation arrangements create conflicts of interest on the part of the service provider that might affect the quality of the services to be performed. These responsibilities are ongoing. After initially selecting service providers and investments for their plans, fiduciaries are required to monitor plan fees and expenses to determine whether they continue to be reasonable and whether there are conflicts of interest.

EBSA's Compliance Assistance Activities: EBSA assists plan fiduciaries and others in understanding their obligations under ERISA, including the importance of understanding service provider fees and relationships, by providing interpretive guidance and making related materials available on its Web site. One such publication developed by EBSA is *Understanding Retirement Plan Fees and Expenses*, which provides general information about plan fees and expenses. In conjunction with the Securities and Exchange Commission, we also developed a fact sheet, "Selecting and Monitoring Pension Consultants – Tips for Plan Fiduciaries." This fact sheet contains a set of

questions to assist plan fiduciaries in evaluating the objectivity of pension consultant recommendations.

EBSA also has made available on its Web site a model "401(k) Plan Fee Disclosure Form" to assist fiduciaries of individual account pension plans when analyzing and comparing the costs associated with selecting service providers and investment products. This form is the product of a coordinated effort of the American Bankers Association, Investment Company Institute, and the American Council of Life Insurers.

To help educate plan sponsors and fiduciaries about their obligations under ERISA, EBSA conducts numerous educational and outreach activities. Our campaign, "Getting It Right – Know Your Fiduciary Responsibilities," includes nationwide educational seminars to help plan sponsors understand the law. The program focuses on fiduciary obligations, especially related to the importance of selecting plan service providers and the role of fee and compensation considerations in that selection process. EBSA has conducted 21 fiduciary education programs since May 2004 in different cities throughout the United States. EBSA also has conducted 49 health benefits education seminars, covering nearly every state, since 2001. Beginning in February 2005, these seminars added a focus on fiduciary responsibilities. EBSA will continue to provide seminars in additional locations under each program.

Disclosures to Participants Under the Current Law: ERISA currently provides for a number of disclosures aimed at providing participants and beneficiaries information about their plans' investments. For example, information is provided to participants through summary plan descriptions and summary annual reports. Under the Pension Protection Act of 2006, plan administrators are required to automatically furnish pension benefit statements to plan participants and beneficiaries. The Department issued Field Assistance Bulletins in December 2006 and in October 2007 to provide initial guidance on complying with the new statutory requirements. Statements must be furnished at least once each quarter, in the case of individual account plans that permit participants to direct their investments, and at least once each year, in the case of individual account plans that do not permit participants to direct their investments. Other disclosures, such as copies of the plan documents, are available to participants on request.

Additional disclosures may be required by the Department's rules concerning whether a participant has "exercised control" over his or her account. ERISA section 404(c) provides that plan fiduciaries are not liable for investment losses which result from the participant's exercise of control. A number of conditions must be satisfied, including that specified information concerning plan investments must be provided to plan participants. Information fundamental to participants' investment decisions must be furnished automatically. Additional information must be provided on request.

EBSA Participant Education and Outreach Activities: EBSA is committed to assisting plan participants and beneficiaries in understanding the importance of plan fees and expenses and the effect of those fees and expenses on retirement savings. EBSA has developed educational brochures and materials available for distribution and through our Web site. EBSA's brochure entitled *A Look at 401(k) Plan Fees for Employees* is targeted to participants and beneficiaries of 401(k) plans who are responsible for directing their own investments. The brochure answers frequently asked questions about fees and highlights the most common fees, and is designed to encourage participants to make informed investment decisions and to consider fees as a factor in decision making. Last fiscal year, EBSA distributed over 5,400 copies of this brochure, and over 46,000 visitors viewed the brochure on our Web site.

More general information is provided in the publications, *What You Should Know about Your Retirement Plan* and *Taking the Mystery out of Retirement Planning*. In the same period, EBSA distributed over 86,000 copies of these two brochures, and almost 102,000 visitors viewed these materials on our Web site. EBSA's *Study of 401(k) Plan Fees and Expenses,* which describes differences in fee structures faced by plan sponsors when they purchase services from outside providers, is also available.

Regulatory Initiatives: EBSA currently is pursuing three initiatives to improve the transparency of fee and expense information to participants, plan sponsors and fiduciaries, government agencies and the public. We began these initiatives, in part, to address concerns that participants are not receiving information in a format useful to them in making investment decisions, and that plan fiduciaries are having difficulty getting needed fee and compensation arrangement information from service providers to fully satisfy their fiduciary duties. The needs of participants and plan fiduciaries are changing as the financial services industry evolves, offering an increasingly complex array of products and services.

Disclosures to Participants - EBSA currently is developing a proposed regulation addressing required disclosures to participants in participant-directed individual account plans. This regulation will ensure that participants have concise, readily understandable information they can use to make informed decisions about the investment and management of

REGULATORY UPDATE

their retirement accounts. Special care must be taken to ensure that the benefits to participants and beneficiaries of any new requirement outweigh the compliance costs, given that any such costs are likely to be charged against the individual accounts of participants.

On April 25, 2007, the Department published a Request for Information to gather data to develop the proposed regulation. The Request for Information invited suggestions from plan participants, plan sponsors, plan service providers, consumer advocates and others for improving the current disclosures applicable to participant-directed individual account plans and requested analyses of the benefits and costs of implementing such suggestions. The Department specifically invited comment on the recommendation of the Government Accountability Office that plans be required to provide a summary of all fees that are paid out of plan assets or directly by participants, as well as other possible approaches to improving the disclosure of plan fee and expense information.

In connection with this initiative, EBSA is also working with the Securities and Exchange Commission to develop a framework for disclosure of information about fees charged by financial service providers, such as mutual funds, that would be more easily understood by participants and beneficiaries. Improved mutual fund disclosure would assist plan participants and beneficiaries because a large proportion of 401(k) plan assets are invested in mutual fund shares. We are working closely with the SEC to ensure that the disclosure requirements under our respective laws are complementary.

We are hopeful that improved fee disclosure will assist plan participants and beneficiaries in making more informed decisions about their investments. Better disclosure could also lead to enhanced competition between financial service providers which could lead to lower fees and enhanced services.

Disclosures to Plan Fiduciaries - EBSA will soon be issuing a proposed regulation amending its current regulation under ERISA section 408(b)(2) to clarify the information fiduciaries must receive and service providers must disclose for purposes of determining whether a contract or arrangement is "reasonable," as required by ERISA's statutory exemption for service arrangements. Our intent is to ensure that service providers entering into or renewing contracts with plans disclose to plan fiduciaries comprehensive and accurate information concerning the providers' receipt of direct and indirect compensation or fees and the potential for conflicts of interest that may affect the provider's performance of services. The information provided must be sufficient for fiduciaries to make informed decisions about the services that will be provided, the costs of those services, and potential conflicts of interest. The Department believes that such disclosures are critical to ensuring that contracts and arrangements are "reasonable" within the meaning of the statute. This proposed regulation currently is under review within the Administration.

Disclosures to the Public - EBSA will soon promulgate a final regulation revising the Form 5500 Annual Report filed with the Department to complement the information obtained by plan fiduciaries as part of the service provider selection or renewal process. The Form 5500 is a joint report for the Department of Labor, Internal Revenue Service and Pension Benefit Guaranty Corporation that includes information about the plan's operation, funding, assets, and investments. The Department collects information on service provider fees through the Form 5500 Schedule C.

Consistent with recommendations of the ERISA Advisory Council Working Group, the Department published, for public comment, a number of changes to the Form 5500, including changes that would expand the service provider information required to be reported on the Schedule C. The proposed changes more specifically define the information that must be reported concerning the "indirect" compensation service providers received from parties other than the plan or plan sponsor, including revenue sharing arrangements among service providers to plans. The proposed changes to the Schedule C were designed to assist plan fiduciaries in monitoring the reasonableness of compensation service providers receive for services and potential conflicts of interest that might affect the quality of those services. EBSA has completed its review of public comments on the proposed Schedule C and other changes to the Form 5500 and expects to have a final regulation and a notice of form revisions published within the next few weeks.

We intend that the changes to the Schedule C will work in tandem with our 408(b)(2) initiative. The amendment to our 408(b)(2) regulation will provide up front disclosures to plan fiduciaries, and the Schedule C revisions will reinforce the plan fiduciary's obligation to understand and monitor these fee disclosures. The Schedule C will remain a requirement for plans with 100 or more participants, which is consistent with long-standing Congressional direction to simplify reporting requirements for small plans.

EBSA's Enforcement Efforts: EBSA has devoted enforcement resources to this area, seeking to detect, correct and deter violations such as excessive fees and expenses, and failure by fiduciaries to monitor on-going fee structure arrangements. Over the past nine years, we closed 354 401(k) investigations involving these issues, with monetary results of over $64 million.

In carrying out its enforcement responsibilities, EBSA conducts civil and criminal investigations to determine whether the provisions of ERISA or other federal laws related to employee benefit plans have been violated. EBSA regularly works in coordination with other federal and state enforcement agencies, including the Department's Office of the Inspector General, the Internal Revenue Service, the Department of Justice (including the Federal Bureau of Investigation), the Securities and Exchange Commission, the PBGC, the federal banking agencies, state insurance commissioners, and state attorneys general.

EBSA is continuing to focus enforcement efforts on compensation arrangements between pension plan sponsors and service providers hired to assist in the investment of plan assets. EBSA's Consultant/Adviser Project (CAP), created in October 2006, addresses conflicts of interest and the receipt of indirect, undisclosed compensation by pension consultants and other investment advisers. Our investigations seek to determine whether the receipt of such compensation violates ERISA because the adviser or consultant used its status with respect to a benefit plan to generate additional fees for itself or its affiliates. The primary focus of CAP is on the potential civil and criminal violations arising from the receipt of indirect, undisclosed compensation. A related objective is to determine whether plan sponsors and fiduciaries understand the compensation and fee arrangements they enter into in order to prudently select, retain, and monitor pension consultants and investment advisers. CAP will also seek to identify potential criminal violations, such as kickbacks or fraud.

Concerns Regarding Legislative Proposals: While I am pleased that the Department's regulatory initiatives and the legislative proposals introduced in Congress share the common goal of providing increased transparency of fee and expense information, I am concerned that legislative action could disrupt the Department's ongoing efforts to provide these important disclosures. I am also concerned by proposals that would mandate specific investment options – limiting the ability of employers and workers together to design plans that best serve their mutual needs – or that would mandate lengthy, detailed disclosures to participants. Participants are most likely to benefit from concise disclosures that allow them to meaningfully compare the investment options in their plans. In response to our April Request for Information, the Department received many comments highlighting the importance of brevity and relevance in disclosures to participants. The regulatory process is well-suited to resolving the many technical issues arising as we seek to strike the proper balance in providing participants with cost effective, concise, meaningful information.

Conclusion

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify before you today. The Department is committed to ensuring that plans and participants pay fair, competitive and transparent prices for services that benefit them – and to combating instances where fees are excessive or hidden. We are moving as quickly as possible consistent with the requirements of the regulatory process to complete our disclosure initiatives, and we believe they will improve the retirement security of America's workers, retirees and their families. I will be pleased to answer any questions you may have.

OTS: Personal Transactions in Securities – Final Rule

Background

In June 2007, the Office of Thrift Supervision (OTS) adopted an interim final rule (Interim Rule) that requires certain officers and employees of savings associations to file reports of their personal securities transactions with the savings association no later than thirty calendar days after the end of each calendar quarter. Before OTS adopted the Interim Rule, persons subject to the rule were required to file such reports within ten business days after the end of each calendar quarter. The thirty-calendar-day period is consistent with the filing requirement for persons in similar positions at investment companies who file such reports under regulations of the Securities and Exchange Commission (SEC). The OTS is adopting a final rule that is identical to the Interim Rule and the effective date is November 7, 2007.

Information

On June 1, 2007, OTS published the Interim Rule. The preamble to the Interim Rule included a request for public comment. The Interim Rule amended 12 CFR 551.150(a) by changing the time period required for officers and employees who are subject to the rule to file personal securities trading reports with the savings association. Before OTS adopted the Interim Rule, the affected officers and employees had been required to file such reports with the savings association within ten business days of the end of each calendar quarter. The Interim Rule changed the ten business day period to no later than thirty calendar days.

OTS received two comments, from a trade association and a savings and loan holding company, regarding the Interim Rule. Both of the comments strongly support the Interim Rule. The

commenters believe that it is appropriate for the time period provided for submitting reports under section 551.150(a) to be consistent with analogous SEC requirements. In addition, the commenters support the rule because it reduces regulatory burden. Having considered the comments, OTS is adopting a final rule that is identical to the Interim Rule.

SEC: SEC and FINRA Launch New Initiative to Assist Chief Compliance Officers at Broker-Dealer Firms

Information

On October 30, 2007, the Securities and Exchange Commission and the Financial Industry Regulatory Authority (FINRA) today announced a new initiative to further promote strong compliance practices at broker-dealer firms for the protection of investors.

Similar to the SEC's ongoing *CCOutreach Program* for investment advisers and investment company chief compliance officers, the *CCOutreach BD* program will help broker-dealer chief compliance officers (CCOs) ensure effective communication about compliance risks, maintain effective compliance controls, and foster strong compliance programs within their firms.

“This is an opportunity for broker-dealers and their regulators to learn from one another about how best to ensure compliance with the securities laws,” said SEC Chairman Christopher Cox.

FINRA CEO Mary L. Schapiro said, “Through its education and training programs, FINRA devotes considerable resources to compliance education – not just for compliance officers, but for broker-dealers' frontline staff as well. This new CCOutreach program will provide a unique opportunity for compliance chiefs across the country to discuss priority topics directly with regulators – and they can participate in shaping the agenda for those discussions themselves.”

The SEC's Office of Compliance Inspections and Examinations, in coordination with the Division of Market Regulation, will sponsor the *CCOutreach BD* program together with FINRA. The program will feature a National Seminar at SEC headquarters in Washington, D.C., tentatively scheduled for March 2008, as well as regional compliance seminars across the country. These meetings will provide the opportunity for open discussions on effective compliance practices and timely compliance issues in ever-changing markets.

To ensure that the National Seminar includes the compliance topics of most interest to broker-dealer CCOs, the SEC and FINRA are soliciting input from CCOs on topics of interest. A list of potential agenda items for the National Seminar may be found on the SEC Web site at http://www.sec.gov/info/bdccoutreach.htm and on the FINRA Web site at www.finra.org/bdccoutreach. Detailed information about the National Seminar and regional seminars also will be posted on those Web pages as it becomes available.