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MFDF Releases Report on Board Self-Assessments

In a recent report entitled "Practical Guidance for Directors on Board Self-Assessments," the Mutual Fund Directors Forum published guidance for boards on the substance of, and process for, undertaking self-evaluations. **While acknowledging that "a board self-assessment is not a one-size-fits-all exercise," it recommends that every board:**

- **"ensure that every director is involved;**
- provide all directors with **adequate opportunity to discuss the findings** that are made during the process; and
- **plan follow-up action after the self-assessment** is complete, based on the conclusions reached during the process."

The report suggests that boards take their self-assessments as an **"opportunity to ask difficult, thought-provoking questions.** A robust self-assessment will continually challenge directors to take a hard look at their board practices and avoid validating existing practices without regard to whether those practices remain in the best interest of fund shareholders."

The report further recommends that boards **periodically review the self-assessment process as opposed to only the results of the assessment.** "Although a board may benefit from using the same process for several years to establish continuity and allow for comparisons to be made from year to year, self-assessments should evolve over time to meet changing industry practices and changes within the board itself."

The MFDF report recommends that **each board consider addressing the following topics** in its self-assessment:

- **Number of funds overseen:** whether directors are able to provide effective oversight for each fund.
- **Board composition:** whether the board is the right size and its membership is sufficiently diverse, providing the skills and experience appropriate to discharge its responsibilities, and whether the ratio of independent directors to interested directors is appropriate.
- **Communication with the board:** whether information is provided in a timely fashion and whether the quality of information and the access to flow of information before and between meetings is sufficient.
- **Meeting process:** whether (1) the number, frequency, location and length of meetings are appropriate, (2) the agenda-setting process is adequate and (3) a sufficient amount of executive sessions are scheduled.
- **Committee structure and functions:** whether the committee structure is appropriately tailored to the fund complex and whether the functioning of independent committees is optimal.
- **Board accountability:** whether performance as a board could be improved.

The report acknowledges that appropriate boards also undertake an evaluation of every individual on the board. The report cautions, though, that **"the board needs to make sure that the peer evaluations do not deteriorate and result in blaming a particular director for any board issues or give a forum to directors who have personality conflicts."** The report acknowledges that some boards use third parties to help with the self-assessment and notes that "the most widely used third party in the mutual fund context is counsel to the independent directors."

The report highlights the need for follow-up mechanisms as part of the self-evaluation process: "Self-assessments that provide evaluation but no mechanism for follow-up will not allow directors

the appropriate opportunity to improve their processes over time. . . . **The board should review the action plan at each meeting to ensure that the board continues to monitor its progress throughout the year.**"

Reiterating the notion that self-assessments will vary by board, the **report concludes by highlighting that "regulations allow directors to craft a self-assessment that is most appropriate to their particular board."**

SEC Allows Actively Managed ETFs

In February, the SEC issued a series of exemptive orders allowing actively managed exchange-traded funds to offer their shares. Unlike an index-based ETF whose portfolio mirrors that of a public index, an actively managed ETF portfolio is comprised of securities selected by an active manager in accordance with a stated investment objective and policies.

In 2001, the SEC sought public comment on the concept of actively managed ETFs, inquiring specifically whether the price arbitrage mechanism that drives ETF market price performance could function properly in an actively managed ETF. According to the SEC, "it was unclear . . . at the time whether an adviser to actively managed ETFs would be willing to provide the same degree of transparency as an adviser to index-based ETFs because, for example, disclosure could allow market participants to access the fund's investment strategy." The SEC was "concerned that reduced transparency could expose arbitrageurs to greater investment risk and result in a less efficient arbitrage mechanism."

Each of the four recently issued exemptive orders, however, includes as a primary condition that the applicant ETF maintain portfolio transparency. This portfolio transparency is to be accomplished by disclosing on an ETF's website each business day, before its shares begin trading, the identities and weightings of the securities and other assets in its portfolio. **The condition affords fund managers some protection, though, as the SEC has not required actively managed ETFs (or index-based ETFs) to disclose portfolio holdings in real time.** As the SEC noted in each of the exemptive orders, "under accounting procedures followed by the [applicant ETFs], portfolio trades made on the prior Business Day ("T") will be booked and reflected in NAV on the current Business Day ("T+1")."

Among other conditions, the applicant ETFs agreed to provide prominent prospectus disclosure that fund shares are not individually redeemable, but instead are redeemable only by tendering them in exchange for creation units. Each order also contained the following ETF rule provision: "The requested order will expire on the effective date of any [SEC] rule under the [1940] Act that provides relief permitting the operation of actively managed exchange-traded funds." The SEC proposed such rules in March (see next article).

The SEC has said that, like index-based ETFs, "fully transparent, actively managed ETFs would provide additional

investment choices for investors" and thereby serve the public interest.

SEC Proposes Rules to Permit Exchange-Traded Funds

The SEC proposed new rules and rule amendments that permit ETFs to be offered without obtaining SEC exemptive relief, facilitate investments in ETFs by investment companies and allow ETFs to provide retail investors with prospectuses similar to those offered by mutual funds. The SEC's goal is to "eliminate unnecessary regulatory burdens and to facilitate greater competition and innovation among ETFs" and to "provide more useful information to individual investors." If adopted, the proposed rules and amendments would greatly enhance the ability of ETF sponsors to offer new products quickly, and would increase competition between ETFs and mutual funds for both institutional and retail investors.

Eliminating the Need for Exemptive Relief

The SEC proposes to eliminate the need for exemptive relief for ETFs that comply with certain conditions. Among these conditions are that the ETF must:

- **Have portfolio transparency.** An ETF must either (i) disclose on its website each business day the identities and weightings of the component securities and other assets it holds or (ii) have a stated investment objective of obtaining returns that correspond to the returns of a securities index whose provider discloses on its website the identities and weightings of the component securities and other assets of the index;
- **Be listed on a national securities exchange;**
- **Disclose its intraday value.** The national securities exchange on which the ETF is listed would have to disseminate the ETF's intraday value at regular intervals during the trading day; and
- **Adhere to certain disclosure requirements.**

An ETF could not to market itself as an open-end fund or mutual fund. Also, **an ETF would have to identify itself in any sales literature as an ETF that does not sell or redeem individual shares** (ETFs only issue "creation units" to broker-dealers, who in turn sell ETF shares to individual investors), and **explain that investors may only purchase or sell individual ETF shares in secondary market transactions that do not involve the ETF.** Finally, an ETF must disclose on its website the prior day's NAV and closing market price (and the difference between the two values).

Mutual Fund Investments in ETFs

The SEC also proposes to permit investment companies to invest in ETFs in excess of current statutory limits, subject to the following conditions:

- **the acquiring mutual fund cannot control the ETF,** cannot be presumed to control the ETF by virtue of owning

25 percent or more of its shares, and cannot seek to exercise control over the ETF;

- **the ETF cannot be a fund of funds;** and
- **the acquiring fund's sales charges and service fees must comply with limits set by FINRA.**

These conditions are intended to facilitate investments in ETFs while preventing "historical abuses that result from pyramiding and the threat of large-scale redemptions and may arise in connection with investments in ETFs." If adopted, the SEC's proposal would allow an investment company to invest in ETFs with fewer restrictions than exist for an investment into another mutual fund.

Amendments to ETF Prospectus

The SEC proposes several amendments to Form N-1A, the registration form used by open-end mutual funds to register shares with the SEC, to accommodate the form's use by ETFs. The goal of these amendments is to make an ETF's prospectus better "designed to meet the needs of investors (including retail investors) who purchase shares in secondary market transactions rather than financial institutions purchasing creation units directly from the ETF." Among the proposed requirements are:

- disclosure of the ETF's returns based on market price and NAV, rather than just NAV;
- disclosure that the ETF's shares can only be bought and sold on the secondary market through a broker-dealer;
- disclosure of the possible payment of brokerage commissions in connection with secondary market transactions; and
- comparison of an index-based ETF's performance to its underlying index.

Comment Period

The SEC has asked for comments by May 19.

IDC Weighs in on Summary Prospectus

The Independent Directors Council recently commented on the SEC's summary prospectus proposal. Under the SEC's proposal, a mutual fund would be able to provide a summary prospectus to investors instead of the current full-length prospectus, subject to certain conditions (see the February 2008 *Investment Management Update* article entitled "SEC Proposes New Rules Permitting Summary Prospectus").

While endorsing the proposal and commending the SEC on its initiative, **the IDC made the following observations:**

- **Quarterly updating requirements:** The SEC proposed quarterly updating requirements of the performance and holdings information in the summary prospectus. The IDC noted that "...the costs and operational difficulties associated with the proposal could discourage funds

from using the summary prospectus." Instead of those quarterly updates, the IDC recommended an annual update of this information with clear disclosure in the summary prospectus directing investors to quarterly updates accessible either online or through a toll-free telephone number.

- **Required disclosure of a portfolio's top ten holdings:** The IDC suggested either eliminating the proposal that a fund disclose its top ten holdings or at least eliminating the need to update the holdings on paper (using, instead, references to links that will yield the most recently filed Form N-Q, which includes a fund's complete portfolio holdings, on fund websites.) According to the IDC, "...the top ten holdings may be of limited value to investors looking for an overview of information about a fund's investment."
- **Fee Table Placement:** The SEC proposed moving the fee table from its current location, directly following the fund's investment objective, strategies, risks and performance, to almost the front of the prospectus following the disclosure of the fund's investment objective in the summary prospectus. The IDC commented that the fee table should be left in its current location to keep all information regarding a fund's key investment characteristics in one location.
- **Portfolio Turnover Rates:** The SEC proposed mandatory disclosure of the portfolio turnover rate for the last fiscal year with an accompanying explanation of its effect on transaction costs and fund performance. The IDC is concerned "...that disclosure of a fund's portfolio turnover rate for just a one-year period, in some instances, could be misleading." The IDC instead advocated disclosing portfolio turnover rate information for each of the past three fiscal years with the option of explaining any fluctuations.
- **Summary Prospectus Length:** While in its proposal the SEC shares its expectation that a summary prospectus would be no more than three or four pages in length, the SEC's proposal does not require a specific page limit. The IDC stated that it would prefer that a page limit be included in the final rules and advocates for a four or five page summary prospectus. The IDC explained that it is "...concerned that the potential for disclosure 'creep' may lead to an expansion of the document over time and undermine its usefulness."
- **Director Liability:** The SEC suggested that the liability of fund directors under the anti-fraud provisions of the Securities Act of 1933 would not extend to the summary prospectus. Specifically, the SEC noted that "...a Summary Prospectus would be filed as part of the registration statement, but would not be deemed a part of the registration statement for purposes of Section 11 of the Securities Act." The IDC agreed with the SEC and has encouraged the SEC to reaffirm this decision in the final rules.

The comment period for the proposed rules expired on February 28.

SEC Settles Municipal Bond Mispricing Case

The SEC recently settled an action against Heartland Advisors, Inc., a Milwaukee-based investment adviser, and several of its current and former employees, for securities law violations relating to the alleged mispricing of certain municipal bonds owned by the Heartland High-Yield Municipal Bond Fund and the Heartland Short Duration High-Yield Municipal Fund. The settlement includes, among other things, the payment of civil penalties, disgorgement, and prejudgment interest totaling nearly \$4 million. The SEC settlement order alleges that:

- The pricing procedures established by the Funds' board of directors required the adviser's internal pricing committee to use valuations provided by FT Interactive Data Corporation for certain debt securities, including the municipal bonds at issue, and to review those valuations to ensure that they were "sufficiently timely and accurate."
- Beginning in late 1999, the Funds' portfolio managers learned that certain municipal projects underlying several bonds held by the Funds had gone into default or were failing. However, the adviser's pricing committee "did not fully consider the implications of these events for the valuations of the affected bonds" and continued to use valuations provided by FT, which did not begin to reduce its valuations of the affected bonds until March 2000.
- On October 12, 2000, the adviser's pricing committee determined that there was no basis for concluding that fair value prices provided by the adviser's Fixed Income Department (which were lower than those provided by FT) were more reliable than FT's valuations and continued to use FT's valuations of the bonds.
- On October 13, 2000, after the SEC denied the adviser's request to permit the Funds to suspend redemptions, the adviser's pricing committee applied across-the-board haircuts to the bonds based on, among other things, the Funds' internal liquidity problems rather than factors specific to each individual bond, **causing the NAVs of the High-Yield Municipal Bond Fund and Short Duration High-Yield Municipal Fund to decline by 69.4% and 44.0%, respectively, from the previous day.**

The SEC noted that, based on information presented to the board during the period indicated above, **the board "should have known that the prices at which the Funds carried their bonds did not reflect the bonds' 'fair value.'"** The board's role in this matter was addressed in greater detail in a 2003 SEC order settling an action against four of the Funds' independent directors. In that order, the SEC required that the directors cease and desist from committing or causing any violations under various securities laws, alleging that they, among other things:

- permitted and did not rectify "the haircut applied to the Funds on October 13," which the directors "knew or should have known resulted in prices that did not represent the fair values of the bonds," having been informed that the Funds' portfolio managers had "expressed confidence that [the bonds] could be sold currently at a higher value" than was applied by the pricing committee;
- **"failed to take adequate steps to follow up on their requests for information from Heartland Advisors,** when they were on notice of the problems with the prices of the Funds' securities"; and
- **"failed to expressly instruct Heartland Advisors to disregard Interactive Data's prices, or to correct the prices of the Funds' bonds,** when they knew or should have known that those prices did not reflect the bonds' fair value."

INVESTMENT MANAGEMENT AND FINANCIAL MARKETS GROUP

Cameron S. Avery
312-807-4302
cavery@bellboyd.com

Kevin R. Bettsteller
312-807-4442
kbettsteller@bellboyd.com

Paul H. Dykstra
312-781-6029
pdykstra@bellboyd.com

Jennifer C. Esquibel
312-807-4262
jesquibel@bellboyd.com

David P. Glatz
312-807-4295
dglatz@bellboyd.com

Alan Goldberg
312-807-4227
agoldberg@bellboyd.com

Elizabeth H. Hudson
312-807-4376
ehudson@bellboyd.com

Anna Paglia
312-781-7163
apaglia@bellboyd.com

Andrew T. Pfau
312-807-4386
apfau@bellboyd.com

Paulita A. Pike
312-781-6027
ppike@bellboyd.com

Eric S. Purple
202-955-7081
epurple@bellboyd.com

Bruce A. Rosenblum
202-955-7087
brosenblum@bellboyd.com

Donald S. Weiss
312-807-4303
dweiss@bellboyd.com

Gwendolyn A. Williamson
202-955-7059
gwilliamson@bellboyd.com

Stacy H. Winick
202-955-7040
swinick@bellboyd.com

Celeste L. Clayton • Paralegal • 312-558-5019
cclayton@bellboyd.com

BELL BOYD
BELL, BOYD & LLOYD LLP

www.bellboyd.com

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70 West Madison Street
Chicago, Illinois 60602
t. 312-372-1121

3580 Carmel Mountain Road
San Diego, California 92130
t. 858.509.7400

1615 L Street, N.W.
Washington, D.C. 20036
t. 202-466-6300

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