2016 MUTUAL FUNDS AND INVESTMENT MANAGEMENT CONFERENCE

INVESTMENT COMPANY INSTITUTE®

MARCH 13–16, 2016

JW Marriott Grande Lakes • Orlando, FL

Table of Contents

POWERPOINT PRESENTATIONS

MONDAY, MARCH 14

TUESDAY, MARCH 15

WEDNESDAY, MARCH 16

SUPPLEMENTAL MATERIALS

Session 1-B: Navigating the Current Mutual Fund Litigation Landscape

Session 1-C: Making Sense of Equity Market Structure: Complexities and Conflicts

Session 1-D: It Takes a Village: Fund Relationships with Service Providers and Intermediaries

Session 2-A: Across the Board: A Discussion of Hot Topics Affecting Fund Boards

Session 2-C: Running for Cover: Derivatives Investments Under the 1940 Act

Session 2-D: Rules of Engagement: Funds' Interaction with Their Portfolio Companies

Ethics: "Nudging" Better Behavior

SESSION 1-A: RIC Tax Update

Karen Lau Gibian, Moderator
Investment Company Institute

Scott Meissner
TIAA

Jessica Reif-Caplan
Fidelity Investments

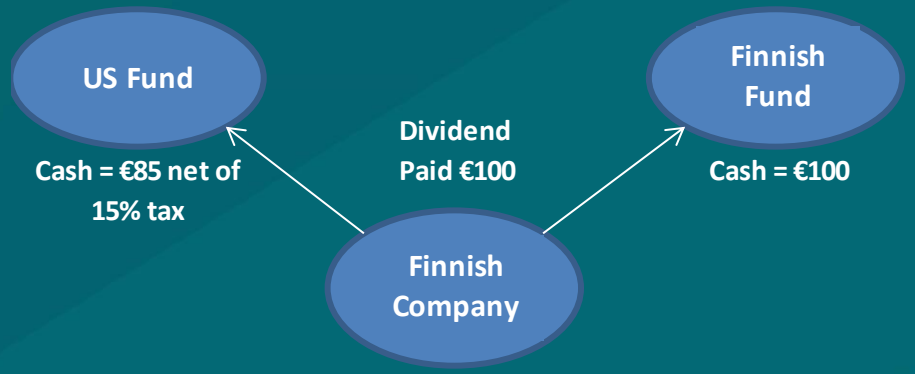
William P. Zimmerman
Morgan, Lewis & Bockius LLP

- EU Reclaims
- Money Market Fund Reform Tax Issues
- SEC Derivatives Release – Tax Implications for Commodity Funds
- Section 871(m) Regulations on Dividend Equivalents
- Common Reporting Standard

EU Reclaims

EU Tax Reclaims: Background

- Article 63 of the Treaty on the Functioning of the EU ("TFEU")
  - Free Movement of Capital.
- Case Rulings
  - Established that Article 63 is violated if an EU Member State exempts its resident funds from tax while imposing tax on "comparable" foreign funds.
  - Established that this protection is available to "comparable" funds of non-EU Member States.
  - More recent cases (in Sweden and Finland) established that US funds are comparable to local funds and entitled to recovery under Article 63.



EU Tax Reclaims: Shifting Focus

- Shifting Focus
  - Shifting from key principles to how to apply country by country and entity by entity
  - Key Elements of “comparability analysis”
  - Strength of exchange of information mechanisms

EU Reclaims: Decision Making Process

- Cost/Benefit analysis (country-by-country)
  - Benefit: Claim value, interest if applicable
  - Cost: Filing cost, internal costs, court costs, translation costs, IRS Cost
- Ultimate probability of success by Country
  - Strength of legal argument
  - Progress of cases and success rates
  - Tactics implemented by each EU country

EU Tax Reclaims: Current Landscape

EU Jurisdiction	Statute of Limitations (Years)	Current Status		Litigation in Progress	
		EU UCITS	US RICs	EU Funds	US Funds
Austria	5		2/3		
Belgium	5 (including claim year)	Newly paying	2		
Denmark	5		3		
Finland	5		1 (Newly paying)		
France	2		1		√
Germany	4		2 (But delaying)		
Hungary	N/A (No WHT)		N/A		
Italy	4		2 (But questionable)		
Netherlands	1 to 3 (Unclear)		3	√	√
Norway	N/A (Non-EU but EEA)		N/A		N/A
Poland	5		1 / 1		
Portugal	2 to 4		2		
Spain	Jan. 1, 2011 onwards		2		√
Sweden	5		1 (Newly paying)		

Legend

Green — Refunds made

Yellow — Claims filed but no known refunds to date

1 = Strongest claim
2 = Strong claim
3 = Least certain claim
N/A = Not applicable

Accounting/Reporting Impacts and Considerations

- When should a fund recognize pending EU tax refund?
- Should a corresponding liability be accrued?
- Should withholding tax be accrued going forward?
- When if at all should a fund include footnote disclosures?

Notice 2016-10

Gating Items for Netting Method

- Refunded taxes were originally passed through under §853(b) and RIC makes the same election in the refund year
- Economic benefit of the refund (and any interest) "*primarily inures to the RIC's refund year shareholders*"
- RIC cannot be owned "predominantly" by insurance companies or fund managers
  - Requirement exists because variable annuity funds do not raise the same shareholder identification issues as retail funds
  - Creates potential issue with the number of amended returns insurance companies may have to file as refunds are realized over time from multiple countries and for multiple years

Notice 2016-10

Carryovers

- RIC must have enough current year foreign tax credits to fully offset the amount of the refund (*i.e.*, no carryovers of excess refunds to future years)
  - In order for the IRS and Treasury to issue generally applicable guidance in advance of reaching consensus on the carryover issue, the Notice carves out carryover situations
  - This substantially increases the likelihood a closing agreement will be necessary, particularly if larger EU countries begin to pay
  - It also creates a problematic cliff effect, where $1 of refund in excess of current-year FTC makes you ineligible for netting under the Notice

Notice 2016-10

Carryovers

- The ICI has requested that the IRS and Treasury permit carryovers of excess FTC reductions for a reasonable period and with a reasonable interest charge
- A netting mechanism with a reasonable carryover period:
  - Reduces substantially the number of closing agreements that taxpayers and the IRS will have to manage
  - Removes the cliff effect caused by a *de minimis* excess credit reduction

Notice 2016-10

Pre-Refund Interest

» Capped at the amount actually received from the EU country under §905(c)(5)

Post-Refund Interest

» The Notice does not address the payment of post-refund interest to the IRS under §905(c)(5)

Reporting

» Report details of Netting on Form 1118

Money Market Fund Reform: Tax Issues

Further Guidance Requested:

NAV Method

- Permit taxpayers to use the NAV Method on an account-by-account basis.
- Permit shareholders in stable NAV MMFs that charge a liquidity fee to use the NAV Method.
- Confirm that RICs using the NAV Method may use the one-year period ending on 10/31 as the computation period for excise tax purposes.
- Clarify that "fair market value" for purposes of the NAV Method means "the next published NAV per share."

Wash Sales

» Extend the wash sale exemption to stable NAV MMFs that impose a liquidity fee.

Liquidity Fees

» Clarify that a MMF may treat liquidity fees as "paid-in capital", resulting in no gain or income (and no basis reduction) to the fund.

» Provide that a stable NAV MMF that pays out liquidity fees will be deemed to have sufficient E&P to make the distribution a dividend.

Variable Insurance Product Diversification Issues

- Increased pressure on Section 817(h) diversification requirements for funds that support variable insurance contracts that transition to government focus
- 817(h) Test - No more than:
  - 55% of gross assets invested in any one issuer,
  - 70% of gross assets invested in any two issuers,
  - 80% of gross assets invested in any three issuers,
  - 90% of gross assets invested in any four issuers.
- Each government agency or instrumentality is treated as a separate issuer and separately counted for purposes of test.
- Repos generally treated as issued by the counterparty for purposes of test.

Requested Relief

A segregated asset account will be treated as adequately diversified under § 817(h) if:

i. It invests in a single '40 Act-registered fund that qualifies for look-through treatment under Treas. Reg. § 1.817-5(f);

ii. The prospectus states that the fund intends to qualify as a government money market fund under Rule 2a-7;

iii. The fund is authorized to invest in any government securities that are eligible money market fund securities under Rule 2a-7; and

iv. The fund's investment adviser/manager has sole discretion to determine in which government securities and other positions the fund will invest.

Transition-Related Items:

- Permit a non-government MMF with both retail and institutional shareholders to divide into separate retail-only and institutional funds on a tax-free basis prior to compliance date.
- Permit a MMF to treat an adviser contribution (made to boost NAV) as resulting in (i) no income or gain to the fund and (ii) no reduction in basis of fund assets under section 362(c).

SEC Derivatives Release: Tax Implications for Commodity Funds

Status of Commodity Funds in the Market

- *Commodity Funds Fall Short, Study Says*, Wall Street Journal, January 11, 2016
  - Experts still recommend a small amount of commodity exposure for investors because commodity prices tend to be uncorrelated with those of stocks and bonds
  - Costs are key to underperformance
  - Potential market opportunity today???

Status of Private Letter Rulings for CFCs

- We are still in the IRS "pause"
- Not aware of any funds continuing to submit requests for rulings to be placed in queue
- Most funds are proceeding with opinion of counsel:
  - Most opinions require the CFC to make an actual dividend distribution; while some firms will opine that the deemed distributions should be treated as good income
  - There is value in obtaining tax opinions to establish "reasonable cause" under Section 851(i)
  - Recent IRS PLRs for REIT CFCs (See PLR 201605005, (01/29/2016)) – note that such rulings are limited to only CFCs that produce income which would be "good income" if received directly by the REIT

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- SEC announced proposed rulemaking on December 11, 2015, under the Investment Company Act (ICA), to regulate certain types of senior securities transactions made by investment companies, including mutual funds, exchange-traded funds, closed-end funds, and business development companies.
- The types of commitments covered in the proposed rule are "derivatives transactions" (swaps, futures and forwards), "financial commitment transactions" (reverse repos, short sales and firm or standby commitments), and other senior securities transactions

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- The proposed rule imposes the following conditions on a fund's use of a derivatives transaction:
  - Compliance with one of two alternative portfolio limitations: (i) exposure not to exceed 150 percent of net assets (called "exposure-based portfolio limit"), or (ii) exposure not to exceed 300 percent of net assets if the value at risk (VaR) for the portfolio is less than the VaR for the fund's securities (called "risk-based portfolio limit");
  - Daily maintenance of an amount of "qualifying coverage assets" (which must generally be cash or cash equivalents) with respect to each derivatives transaction that is at least equal to the sum of the aggregate mark-to-market and "risk-based" coverage amounts for the transaction;
  - If the fund engages in derivatives transactions with a combined notional value of at least 50 percent of a fund's net assets, or transacts in "complex derivatives," establishment of a formalized derivatives risk management program; and
  - Approval by the fund's board of the fund's choice of portfolio limitation, its asset coverage policies and procedures, and its derivatives risk management program, if applicable.

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- Remember that Representation Regarding Compliance with SEC Release 10666?
  - Fund represents that although Sub will not be registered as an investment company under the 1940 Act, Sub will comply with the requirements of section 18(f) of the 1940 Act, Investment Company Act Release No. 10666, and related SEC guidance pertaining to asset coverage with respect to transactions in commodity futures and other transactions in derivatives.

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- Origin of the Representation:
  - When the first PLRs were issued, the IRS was concerned about the CFC doing something indirectly that the fund couldn't do directly
  - By making the CFC abide by SEC Release 10666 and related guidance, the IRS was comforted that this restriction would support the separateness of the CFC from the Fund for tax purposes

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- Very generally, SEC Release 10666 provides guidance for setting up segregated accounts of equal value to the potential senior security for purposes of complying with section 18(h).

- Under section 18(h), the CFC would need to limit its "asset coverage" to 300%. Asset coverage of a class of securities representing indebtedness of an issuer generally is defined in section 18(h) as the "ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities bears to the aggregate amount of senior securities representing indebtedness of such issuer."

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- Under the Proposed Rule 18f-4 (which will "supersede the guidance [the SEC Staff] provided in Release 10666, as well as guidance provided by [SEC] staff concerning funds' use of derivatives and financial commitment transactions, which [the SEC] would rescind"), the CFC, if abiding by the representation, would need to:
  - Comply with one of two alternative portfolio limitations - either (i) limit of 150% (relative to its net assets) on its aggregate notional "exposure" to senior securities transactions, measured after each transaction in accordance with a prescribed calculation methodology; or (ii) under the risk-based portfolio limit, the CFC could have exposure of up to 300%, provided it also meets a value at risk (VaR) test intended to ensure that the CFC's use of derivatives reduces, rather than magnifies, the CFC's overall exposure to market risk; and
  - Maintain a specified value of "qualifying coverage assets" identified on its books and records (*i.e.,* "earmarked") to manage the risks associated with its derivatives transactions and financial commitment transactions.

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

» For derivatives transactions, the required amount of qualifying coverage assets would be based on mark-to-market value of derivatives transactions, plus an additional risk-based amount, but could only consist of cash and cash equivalents and particular assets that may be delivered by a CFC to satisfy its obligations (*e.g.,* if the CFC has written a call option on a particular security that the CFC owns, then the security would be considered qualifying coverage assets for that transaction).

Consequences of Proposed Rule 18f-4 on CFC PLRs and Opinions

- What are the likely consequences if these new limits are adopted?
  - Will these new limits result in further reduction in performance returns?
  - Will some funds push tax counsel to abandon reliance on the representation?
- Time for IRS to take a position on CFCs?
  - Recommendation to drop this representation

Section 871(m) Regulations: Withholding on Dividend Equivalents

Section 871(m): Dividend Equivalent Withholding

- Regulations treat both US and non-U.S. open-end funds as “brokers”.
- As a result, funds would have new reporting, recordkeeping and withholding obligations.
  - The reporting and recordkeeping obligations apply regardless of whether the transaction would be subject to withholding. For example, even transactions with a delta below 0.8 entered into with a QDD would be subject to these obligations.
- Unlikely any fund would have the knowledge or systems in place to comply with these obligations.
- Until we are given clarification, special attention should be paid to arrangements where a fund is a short party to transactions implicating Section 871(m).

Common Reporting Standard

Common Reporting Standard (CRS)

Standard under which customer financial information is collected, reported, and exchanged

- Developed by OECD and G20 with substantial business input.
- 55 countries adopted the CRS as of 1/1/2016 with first information exchange in 2017; over 40 additional countries are expected to adopt the CRS as of 1/1/2017 with information exchange in 2018.
- The United States is NOT a CRS "participating jurisdiction" – despite FATCA being the CRS model.

Standard based upon FATCA Model 1 intergovernmental agreement

- Financial institutions (FIs) perform due diligence on, and collect information about, all customers.
- Financial account information about reportable non-resident customers reported to local tax authority.
- Local tax authority exchanges this information with tax authority of customer's residence country.

Common Reporting Standard (continued)

Impact on US funds (RICs) investing abroad

- Funds (such as RICs) are "Category 2 investment entity" FIs.
- RICs, nevertheless, are treated as passive non-financial entities (NFEs) – but only because U.S. is a "non-participating jurisdiction."
- FIs in CRS jurisdictions must collect some information from all customers; information about "controlling persons" must be collected by these FIs from passive NFEs (such as RICs) that have accounts with the FI.
- If the controlling person is resident in a non-reportable jurisdiction (such as the U.S.), TIN information is *not* required under the CRS.
- Possibility exists that some countries and/or some FIs may not apply CRS uniformly or correctly.
- OECD is aware of these potential inconsistencies; clarification is being sought.

SESSION 1-B: Navigating the Current Mutual Fund Litigation Landscape

Julia S. Ulstrup, Moderator
ICI Mutual Insurance Company, RRG

Paul B. Goucher
Ameriprise Financial, Inc.

David Kotler
Dechert LLP

Stephen G. Topetzes
K&L Gates LLP

Questions for Discussion

- Where are we now?
  - Section 36(b) Fee Litigation
  - State Law Actions
  - Prospectus Liability/Disclosure-based Litigation
- What might be around the corner?
  - Regulatory Proposals and Priorities
  - Board Focus Areas

Recent Section 36(b) Cases

1. Curran v. Principal Mgt. Co.,
No. 4:09–cv–00433 (S.D. Iowa filed Oct. 28, 2009)

Trial Court

- Motion to Dismiss, 2010 WL 1372232 (Feb. 2, 2010)
- Opposition to Motion to Dismiss, 2010 WL 1372233 (Feb. 22, 2010)
- Reply in Support of Motion to Dismiss, 2010 WL 1372234 (Mar. 4, 2010)
- Opinion, 2010 WL 2889752 (June 8, 2010)
- Motion for Reconsideration, 2010 WL 10090684 (June 30, 2010)
- Opposition to Motion for Reconsideration, 2010 WL 5660063 (July 21, 2010)
- Reply in Support of Motion for Reconsideration, 2010 WL 5660064 (July 28, 2010)
- Opinion on Reconsideration as to Statutory Standing, 2011 WL 223872 (Jan. 24, 2011)

- Plaintiff's Motion for Partial Summary Judgment, 2013 WL 8367153 (Feb. 22, 2013)
- Defendant's Motion for Summary Judgment, 2013 WL 8367074 (Mar. 19, 2013)
- Defendant's Opposition to Plaintiff's Motion for Partial Summary Judgment, 2013 WL 8367154 (Mar. 22, 2013)
- Plaintiff's Reply in Support of Motion for Partial Summary Judgment, 2013 WL 8367127 (Apr. 5, 2013)
- Plaintiff's Opposition to Defendant's Motion for Summary Judgment,2013 WL 8367111 (Apr. 15, 2013)
- Defendant's Reply in Support of Motion for Summary Judgment, 2013 WL 8367109 (Apr. 25, 2013)

2. Santomenno v. John Hancock Life Ins. Co.,
No. 2:10-cv-1655 (D.N.J. filed Mar. 31, 2010), *aff'd*, No. 11-2529 (3rd Cir. Apr. 16, 2012) & No. 13-4367 (3rd Cir. Sept. 26, 2014), *reh'g denied*, No. 13-3467 (Nov. 24, 2014), *cert. denied*, No. 14-1054 (U.S. Apr. 20, 2015)

Trial Court

- Motion to Dismiss, 2010 WL 4597788 (July 16, 2010)
- Opposition to Motion to Dismiss[1]
- Motion to Dismiss Second Amended Complaint
- Opposition to Motion to Dismiss Second Amended Complaint
- Reply in Support of Motion to Dismiss Second Amended Complaint
- Opinion, 2011 WL 2038769 (May 23, 2011)

- Renewed Motion to Dismiss, 2012 WL 12354319 (Dec. 14, 2012)
- Opposition to Renewed Motion to Dismiss
- Reply in Support of Renewed Motion to Dismiss

---

[1] This appendix includes materials that may be available from the court or from PACER but are not currently available on Westlaw.

- Opinion, 2013 WL 3864395 (July 24, 2013)

Court of Appeals

- Brief for Appellants, 2011 WL 4047528 (Sept. 6, 2011)
- Brief for Appellees, 2011 WL 5143881 (Oct. 24, 2011)
- Reply Brief for Appellants
- Opinion, 677 F.3d 178 (Apr. 16, 2012)

- Brief for Appellants, 2014 WL 198098 (Jan. 13, 2014)
- Brief for Appellees, 2014 WL 992541 (Mar. 7, 2014)
- Reply Brief for Appellants, 2014 WL 1400598 (Apr. 7, 2014)
- Opinion, 768 F.3d 284 (3d Cir. 2014)

3. Southworth v. Hartford Inv. Fin. Serv., LLC,
No. 1:10-cv-00878 (D. Del. Filed Oct. 14, 2010) – closed by stipulation (Nov. 7, 2011)

Trial Court

- Motion to Dismiss
- Opposition to Motion to Dismiss
- Reply in Support of Motion to Dismiss
- Order

4. Kasilag v. Hartford Inv. Fin. Serv., LLC,
No. 1:11-cv-01083 (D.N.J. filed Feb. 25, 2011)

Trial Court

- Motion to Dismiss Amended Complaint
- Opposition to Motion to Dismiss Amended Complaint, 2011 WL 7661082 (June 27, 2011)
- Reply in Support of Motion to Dismiss Amended Complaint, 2011 WL 7661084 (July 11, 2011)

- Motion to Dismiss Second Amended Complaint, 2012 WL 1190027 (Jan. 17, 2012)
- Opposition to Motion to Dismiss Second Amended Complaint, 2012 WL 3137412 (Mar. 21, 2012)
- Reply in Support of Motion to Dismiss Second Amended Complaint
- Opinion, 2012 WL 6568409 (Dec. 17, 2012)

5. Turner v. Davis Selected Advisers, L.P.,
No. 08-cv-421 (D. Ariz. filed July 28, 2008), *aff'd*, No. 13-15742 (9th Cir. Sept. 29, 2015)

Trial Court

- Motion to Dismiss, 2008 WL 5184111 (Oct. 6, 2008)

- Opposition to Motion to Dismiss, 2008 WL 6141025 (Dec. 16, 2008)
- Reply in Support of Motion to Dismiss, 2009 WL 805782 (Jan. 29, 2009)

- Motion to Dismiss Amended Complaint
- Opposition to Motion to Dismiss Amended Complaint
- Reply in Support of Motion to Dismiss Amended Complaint, 2009 WL 805781 (Nov. 3, 2009)
- Supplemental Brief in Support of Motion to Dismiss
- Supplemental Opposition to Motion to Dismiss, 2010 WL 4930428 (Sept. 27, 2010)
- Opinion

Court of Appeals
- Brief for Appellants
- Brief for Appellees
- Reply Brief for Appellants, 2014 WL 206956 (May 9, 2014)
- Opinion, 2015 WL 5692324 (Sept. 29, 2015)

6. Reso v. Artisan Partners Ltd. P'ship,
No. 11-cv-873 (E.D. Wis. filed Sept. 16, 2011) – closed by stipulation (Aug. 23, 2012)

Trial Court
- Renewed Motion to Dismiss, 2011 WL 7640588 (Oct. 7, 2011)
- Opposition to Renewed Motion to Dismiss, 2011 WL 7640587 (Oct. 19, 2011)
- Reply in Support of Renewed Motion to Dismiss, 2011 WL 7640586 (Oct. 28, 2011)
- Opinion, 2011 WL 5826034 (Nov. 18, 2011)

- Motion for Summary Judgment, 2012 WL 4075685 (July 16, 2012)
- Opposition to Motion for Summary Judgment
- Reply in Support of Motion for Summary Judgment

7. Sivolella v. AXA Equitable Life Ins. Co.,
No. 11-cv-4194 (D.N.J. filed July 21, 2011) / *Sanford v. AXA Equitable Funds Mgmt. Group, LLC*, No. 3:13-cv-312 (D.N.J., filed Jan. 15, 2013) – consolidated with *Sivolella*

Trial Court
- Motion to Dismiss, 2011 WL 10501114 (Dec. 19, 2011)
- Opposition to Motion to Dismiss, 2012 WL 7678443 (Feb. 2, 2012)
- Reply in Support of Motion to Dismiss, 2012 WL 7678367 (Mar. 5, 2012)
- Opinion, 2012 WL 4464040 (Sept. 25, 2012)

- Briefing on Motions for Summary Judgment – partially under seal
- Trial Brief for Plaintiffs
- Trial Brief for Defendants

8. Laborer's Local 265 Pension Fund v. iShares Trust,
No. 13-cv-00046 (M.D. Tenn. filed Jan. 18, 2013), *aff'd*, No. 13-6486 (6th Cir. Sept. 30, 2014), *cert. denied* (U.S. Mar. 2, 2015) (No. 14-771)

Trial Court

- Motion to Dismiss, 2013 WL 10904759 (Mar. 11, 2013)
- Opposition to Motion to Dismiss, 2013 WL 3465983 (Mar. 28, 2013)
- Reply in Support of Motion to Dismiss, 2013 WL 10904769 (Apr. 8, 2013)
- Sur-Reply in Opposition to Motion to Dismiss, 2013 WL 10904754 (Apr. 15, 2013)
- Opinion, 2013 WL 4604183 (Aug. 28, 2013)

Court of Appeals

- Brief for Appellants, 2014 WL 671724 (Feb. 13, 2014)
- Brief for Appellees, 2014 WL 1109129 (Mar. 17, 2014)
- Reply Brief for Appellants, 2014 WL 1400345 (Apr. 3, 2014)
- Opinion, 769 F.3d 399 (Sept. 30, 2014)

9. Am. Chem. & Equip. Inc. 401(k) Ret. Plan v. Principal Mgmt. Corp.,
No. 2:13-cv-01601 (N.D. Ala. filed Aug. 28, 2013)

Trial Court

- Motion to Dismiss, 2013 WL 9599980 (Oct. 28, 2013)
- Opposition to Motion to Dismiss, 2013 WL 9599957 (Nov. 7, 2013)
- Reply in Support of Motion to Dismiss, 2013 WL 9600007 (Nov. 12, 2013)
- Opinion, 2014 WL 5426908 (Sept. 10, 2014)

- Briefing on Motion for Summary Judgment – filed under seal

10. In re Voya Global Real Estate Fund Shareholder Litig., No. 1:13-cv-01521 (D. Del. filed Aug. 30, 2013)

11. In re Russell Inv. Co. Shareholder Litig., No. 1:13-cv-12631 (D. Mass filed Oct. 17, 2013)

12. Curd v. SEI Invs. Mgmt. Corp.,
No. 2:13-cv-07219 (E.D. Pa. filed Dec. 11, 2013)

Trial Court

- Motion to Dismiss by Adviser, 2014 WL 6632541 (Feb. 24, 2014)
- Opposition to Motion to Dismiss by Adviser, 2014 WL 6632588 (Apr. 28, 2014)
- Reply in Support of Motion to Dismiss by Adviser, 2014 WL 6632508 (May 19, 2014)
- Motion to Dismiss by Nominal Fund Defendants, 2014 WL 6632593 (May 23, 2014)

- Opposition to Motion to Dismiss by Nominal Fund Defendants, 2014 WL 6632528 (June 9, 2014)
- Reply in Support of Motion to Dismiss by Nominal Fund Defendants (June 19, 2014)
- Order Granting Motion to Dismiss with Leave to Amend (Aug. 28, 2014)

- Motion to Dismiss Amended Complaint (Nov. 24, 2014)
- Opposition to Motion to Dismiss Amended Complaint (Jan. 9, 2015)
- Reply in Support of Motion to Dismiss Amended Complaint (Jan. 30, 2015)
- Opinion, 2015 WL 4243495 (July 14, 2015)

13. Zehrer v. Harbor Capital Advisors, Inc.,
No. 1:14-cv-00789 (N.D. Ill. filed Feb. 4, 2014) / *Tumpowsky v. Harbor Capital Advisors, Inc.*, No. 14-cv-7210 (N.D. Ill. Filed Sept. 16, 2014) (consolidated with *Zehrer*)

Trial Court
- Motion to Dismiss by Adviser, 2014 WL 2881380 (Apr. 8, 2014)
- Motion to Dismiss by Nominal Fund Defendant, 2014 WL 2881383 (Mar. 31, 2014)
- Omnibus Opposition to Motions to Dismiss, 2014 WL 2609426 (May 20, 2014)
- Reply in Support of Motion to Dismiss by Adviser, 2014 WL 2609317 (June 10, 2014)
- Reply in Support of Motion to Dismiss by Nominal Fund Defendant, 2014 WL 2609293 (June 10, 2014)
- Opinion, 2014 WL 6478054 (Nov. 18, 2014)

14. In re BlackRock Mut. Funds Advisory Fee Litig.,
No. 3:14-cv-01165 (D.N.J. filed Feb. 21, 2014)

Trial Court
- Motion for Judgment on the Pleadings, 2014 WL 3510032 (June 26, 2014)
- Opposition to Motion for Judgment on the Pleadings, 2014 WL 4106017 (July 25, 2014)
- Reply in Support of Motion for Judgment on the Pleadings
- Opinion, 2015 WL 1418848 (Mar. 27, 2015)

15. Goodman v. J.P. Morgan Inv. Mgmt., Inc.,
No. 2:14-cv-414 (S.D. Ohio filed May 5, 2014) / *Campbell Family Trust v. J.P. Morgan Inv. Mgmt. Inc.*, No. 15-cv-02923 (S.D. Ohio filed Oct. 16, 2015) (consolidated with *Goodman*)

Trial Court
- Motion to Dismiss, 2014 WL 6852660 (July 10, 2014)
- Opposition to Motion to Dismiss, 2014 WL 6852624 (Aug. 28, 2014)
- Reply in Support of Motion to Dismiss, 2014 WL 6852654 (Sept. 23, 2014)
- Opinion, 2015 WL 965665 (Mar. 4, 2015)

16. Kennis v. First Eagle Inv. Mgmt., LLC,
No. 1:14-cv-00585 (D. Del. filed May 7, 2014)

Trial Court

- Motion to Dismiss, 2014 WL 10463655 (July 14, 2014)
- Opposition to Motion to Dismiss, 2014 WL 10463656 (Sept. 11, 2014)
- Reply in Support of Motion to Dismiss, 2014 WL 10463697 (Oct. 9, 2014)
- Opinion, 2015 WL 5886178 (Oct. 8, 2015)

17. In re Davis N.Y. Venture Fund Fee Litig.,
No. 14-cv-4318 (S.D.N.Y. filed Jun. 16, 2014)

Trial Court

- Motion to Dismiss, 2015 WL 1322714 (Mar. 9, 2015)
- Opposition to Motion to Dismiss, 2015 WL 5096437 (Apr. 15, 2015)
- Reply in Support of Motion to Dismiss, 2015 WL 3799376 (May 8, 2015)
- Opinion, 2015 WL 7301077 (Nov. 18, 2015)

18. Redus-Tarchis v. N.Y. Life Inv. Mgmt.,
No. 14-cv-7991 (D.N.J. filed Dec. 23, 2014)

Trial Court

- Motion to Dismiss, 2015 WL 4092470 (June 19, 2015)
- Opposition to Motion to Dismiss, 2015 WL 5185203 (Aug. 18, 2015)
- Reply in Support of Motion to Dismiss
- Opinion, 2015 WL 6525894 (Oct. 28, 2015)

19. Kenny v. Pacific Inv. Mgt. Co.,
No. 14-cv-1987 (W.D. Wash. filed Dec. 31, 2014)

Trial Court

- Motion to Dismiss, 2015 WL 1623147 (Mar. 6, 2015)
- Opposition to Motion to Dismiss, 2015 WL 2160161 (Apr. 20, 2015)
- Reply in Support of Motion to Dismiss, 2015 WL 4075522 (May 20, 2015)
- Opinion

20. Chill v. Calamos Advisors, LLC,
No. 15-cv-1014 (S.D.N.Y. filed Feb. 11, 2015)

Trial Court

- Motion to Dismiss, 2015 WL 4387312 (June 12, 2015)
- Opposition to Motion to Dismiss, 2015 WL 5453664 (Aug. 13, 2015)
- Reply in Support of Motion to Dismiss, 2015 WL 6697983 (Sept. 15, 2015)

21. Ingenhutt v. State Farm Inv. Mgmt. Corp.,

No. 1:15-cv-1303 (C.D. Ill. Filed July 22, 2015)

Trial Court

- Motion to Dismiss
- Opposition to Motion to Dismiss
- Reply in Support of Motion to Dismiss

22. **Wayne County Employees' Ret. System v. Fiduciary Mgmt. Inc.,** No. 15-cv1170 (E.D. Wis. filed Sept. 30, 2015) – closed by stipulation (Jan. 4, 2016)

23. **Kennis v. Metropolitan West Asset Mgmt., LLC,** No. 15-cv-8162 (C.D. Cal. filed Oct. 16, 2015)

Trial Court

- Motion to Dismiss
- Opposition to Motion to Dismiss

24. **North Valley GI Medical Group v. Prudential Investments LLC,** No. 1:15-cv3268 (D. Md. filed Oct. 30, 2015)

Trial Court

- Motion to Dismiss

25. **Ventura v. Principal Mgmt. Corp.,** No. 15-cv-481 (S.D. Iowa filed Dec. 30, 2015)

26. **Obeslo v. Great-West Capital Management, LLC,** No. 16-cv-230 (D. Colo. filed Jan. 29, 2016)

State Law "*Northstar*" Claims

Northstar Financial Advisors Inc. v. Schwab Investments, No. 08-cv-04119 (N.D. Cal. filed Aug. 28, 2008)

Trial Court

- Motion to Dismiss Second Amended Complaint, 2010 WL 5810641 (Nov. 10, 2010)
- Opposition to Motion to Dismiss Second Amended Complaint, 2010 WL 5810644 (Dec. 6, 2010)
- Reply in Support of Motion to Dismiss Second Amended Complaint, 2010 WL 5810645 (Dec. 21, 2010)
- Opinion, 781 F.Supp.2d 926 (Mar. 2, 2011)

- Motion to Dismiss Third Amended Complaint, 2011 WL 10755922 (Apr. 25, 2011)
- Opposition to Motion to Dismiss Third Amended Complaint, 2011 WL 7562020 (June 16, 2011)
- Reply in Support of Motion to Dismiss Third Amended Complaint, 2011 WL 7562018 (June 30, 2011)
- Opinion, 807 F.Supp.2d 871 (Aug. 8, 2011)

- Motion to Dismiss Fourth Amended Complaint, 2015 WL 6452482 (July 24, 2015)
- Opposition to Motion to Dismiss Fourth Amended Complaint, 2015 WL 6452403 (Aug. 26, 2015)
- Reply in Support of Motion to Dismiss Fourth Amended Complaint, 2015 WL 6452496 (Sept. 10, 2015)
- Opinion, 2016 WL 706018 (Feb. 23, 2016)

Court of Appeals

- Opinion on Appeal of Dismissal of Third Amended Complaint, 779 F.3d 1036 (Mar. 9, 2015)

Hampton v. Pacific Inv. Mgt. Co., LLC, No. 15-00131 (C.D. Cal. Filed Jan. 28, 2015)

Trial Court

- Motion to Dismiss, 2015 WL 7693249 (Oct. 5, 2015)
- Opposition to Motion to Dismiss, 2015 WL 6697596 (Oct. 12, 2015)
- Reply in Support of Motion to Dismiss, 2015 WL 7693252 (Oct. 19, 2015)
- Opinion, 2015 WL 7292128 (Nov. 2, 2015)

Forward

Recent Developments in U.S. "Excessive Fee" Litigation

By David A. Kotler and Catherine Wigglesworth

The U.S. mutual fund industry is poised to see significant developments in the ongoing wave of Section 36(b) "excessive fee" litigation. Days apart in August, the Seventh Circuit Court of Appeals affirmed the grant of summary judgment in *Jones v. Harris Associates, L.P.*,[1] while a New Jersey federal court denied defendants' motion for summary judgment in the first of the "manager of managers" cases to reach that stage, *Sivolella v. AXA Equitable Insurance Co.*[2] Together with the recent uptick in the number of cases being brought to challenge fees charged by mutual fund advisers, this area of law merits careful attention by investment advisers, mutual fund boards, and their counsel.

Background

Section 36(b) of the Investment Company Act of 1940 imposes a fiduciary duty on the investment adviser of a mutual fund with respect to the fees charged to the fund, and creates a narrow private right of action permitting shareholders to challenge the fees paid in the one year preceding the filing of the complaint.

While the statute itself does not detail the analysis that a court should undergo when determining whether fees are legally excessive, the Second Circuit in the seminal *Gartenberg* case[3] held that fees should only be considered excessive if "so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The Second Circuit identified six factors to be considered in determining whether the advisory fees paid by a mutual fund met this standard. These factors, often referred to as the "*Gartenberg* factors," are: (i) the nature and quality of the services provided to the fund and its shareholders; (ii) the profitability of the fund to the adviser; (iii) the extent to which the adviser realizes economies of scale as the fund grows in size; (iv) the fee structure of comparable funds; (v) the independence, expertise, care, and conscientiousness of the fund's board of trustees in evaluating the adviser's compensation; and (vi) any collateral benefits that accrue to the adviser because of its relationship with the fund. Following *Gartenberg*, the great majority of courts considering section 36(b) claims have adopted the Second Circuit's analysis.

The *Jones v. Harris* Case

In *Jones v. Harris Associates, L.P.*, initially filed in 2004, the plaintiffs alleged that the fees paid by the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (collectively, Oakmark Funds) to their adviser Harris Associates L.P. (Harris) were legally excessive in violation of section 36(b). The district court granted summary judgment to Harris in 2007, applying *Gartenberg* and holding that, for purposes of section 36(b), "[w]hat matters is whether there is a fundamental disconnect between what the Funds paid and what the services were worth; on this score Plaintiffs have not set forth an issue of fact that, if resolved in their favor, could lead to a finding that Harris had breached its [section] 36(b) duty."[4] Following this ruling, the plaintiffs appealed to the Seventh Circuit.

The Seventh Circuit's 2008 Opinion *("Jones I")*

On appeal, the Seventh Circuit affirmed the district court's judgment, using a different rationale. Despite

the widespread adoption of the *Gartenberg* analysis, the Seventh Circuit Court of Appeals in *Jones*[5] took a different route – adopting a market-based standard for judging whether an investment advisory fee is excessive. Thus, the Seventh Circuit held, if the investment advisory fees were honestly negotiated and agreed to by a fund's board of trustees, those fees could not be excessive so as to constitute a breach of fiduciary duty under section 36(b). Supporting the Seventh Circuit's conclusion was its contention that market forces – not judicial regulation – should govern the propriety of mutual fund fees, and its expectation that if fees were too high, investors would "vote with their feet" by withdrawing their investments from the fund.

The Supreme Court's Opinion

The Seventh Circuit's decision, which created a split among the courts of appeal, was appealed to the Supreme Court. In 2010, the Supreme Court issued an opinion reversing the Seventh Circuit. The Supreme Court found the Seventh Circuit's exclusive reliance on free market regulation inappropriate, and adopted the Second Circuit's approach in *Gartenberg* as the appropriate analysis to apply to determine whether a fee was excessive in violation of section 36(b). Accordingly, the Supreme Court found that to establish a violation of section 36(b), a plaintiff must establish that "the fee is outside the range that arm's-length bargaining would produce."

The Court further found that in determining whether the fee was negotiated at arm's length, "a measure of deference to a board's judgment [in approving an investment advisory agreement] may be appropriate in some instances," but that "the appropriate measure of deference varies depending on the circumstances." The Court concluded by emphasizing that "the standard for fiduciary breach under [section] 36(b) does not call for judicial second-guessing of informed board decisions," and remanded the case to the Seventh Circuit for the Seventh Circuit's consideration under the standard set forth by the Supreme Court.

The Seventh Circuit's 2015 Opinion *("Jones II")*

Following a lengthy delay, on August 6, 2015, the Seventh Circuit issued a nonprecedential decision affirming the district court's grant of summary judgment and applying the standard enunciated by the Supreme Court.[6] The Seventh Circuit observed that "the Supreme Court's approach does not allow a court to assess the fairness or reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation." As a result, the Seventh Circuit determined that "the Supreme Court's standard is less favorable to plaintiffs than the one the district court used – yet plaintiffs lost even under the district court's approach." In particular, the Seventh Circuit found dispositive the facts that the fees charged by Harris were comparable to those charged by advisers for comparable funds, and that the fees "could not be called disproportionate in relation to the value of Harris's work," because the Oakmark Funds' performance was better than the average for comparable funds.

Elaborating on these factors, the court observed that the fees "produced by bargaining at other mutual-fund complexes" established the "bargaining range," and that because the fees paid by the Oakmark Funds were within this range – coupled with the fact that such funds performed as well as, if not better than, comparable funds – the fees were not so large that they could not have been the result of arm's length bargaining. The court proceeded to reject the plaintiffs' contention that the fees charged to the Oakmark Funds should be compared not to other mutual funds, but to non-mutual fund clients of Harris. The court found that such a comparison was not appropriate, because the plaintiffs had failed to present evidence tending to show that Harris provided non-mutual fund clients with the same type of services provided to the Oakmark Funds or incurred the same costs. Thus, the Seventh Circuit held that Harris was entitled to summary judgment on plaintiffs' section 36(b) claim.

The Seventh Circuit's *Jones II* decision marks the likely end of the *Jones* saga, which lasted over ten years and touched every level of the federal courts. Consistent with the Supreme Court's ruling, the *Jones II* decision emphasizes that no one factor is dispositive – rather, a court must determine whether, taking all the facts into account, a fee is so disproportionately large that it could not have resulted from arm's length bargaining. If this standard cannot be met on the facts of a particular case, summary judgment is warranted.

Summary Judgment Denied in *Sivolella v. AXA Equitable Insurance Co.*

Also in August, the first of the recent wave of "manager of managers" cases reached the summary

judgment stage. In *Sivolella*, the plaintiffs allege that the advisory and administrative fees paid by 12 funds advised by AXA (Sivolella Funds) are legally excessive because the adviser delegates substantially all its duties to one or more sub-advisers, yet nonetheless charges a fee on top of the fees paid to the sub-advisers.

Oral argument was held on the Motion for Summary Judgment filed by Defendants AXA Equitable Life Insurance Company (AXA) and AXA Equitable Funds Management Group LLC (FMG) in the U.S. District Court for the District of New Jersey on August 5, 2015. Shortly after the argument, in a ruling from the bench, the district court denied the motion – finding issues of material fact as to nearly all of the *Gartenberg* factors.

Argument by Defendants

In their argument, the defendants focused on the high hurdle a plaintiff faces to bring a viable claim under Section 36(b), and the deference accorded to a fully-informed board of trustees. The defendants argued that the plaintiffs' attempt to differentiate *Sivolella*on the basis that sub-advisers were used to manage and advise the funds should be disregarded, since the use of third parties to assist with some services provided to a mutual fund is a commonly-accepted practice. The defendants pointed out that even the very early 36(b) cases (including *Gartenberg*) involved allegations that third parties perform the majority of the work in managing a mutual fund, yet the adviser defendants had prevailed nonetheless.

The defendants emphasized that a disproportionality standard must be used in determining whether the advisory fee is excessive, and that the *Gartenberg* factors inform whether the fee is disproportionately large. In particular, the defendants stated that the law is clear that the business judgment of a fully informed board of trustees is subject to commensurate deference, and if the board process has no defect, it is extremely difficult to show that the fee is disproportionate. The defendants emphasized that while there may be a few quibbles about the process utilized by the Sivolella Funds' Board of Trustees (Board), a number of facts (such as the independence of the great majority of trustees) are not in dispute. The defendants argued that the Board was given a substantial amount of material (including information as to each of the *Gartenberg* factors), and while it is always possible for a plaintiff to identify some additional piece of material that it can allege should have been given to the board, the pertinent standard is whether the board was given *sufficient* information to render it fully informed with respect to the management agreement.

In closing, the defendants urged the district court to consider whether, even giving plaintiffs the benefit of the doubt, it would be possible to find at trial that the fees charged were so disproportionately large that they could not be the result of an arm's length bargain. The defendants submitted that no issue of material fact existed with respect to the key issues relating to the *Gartenberg* analysis, and that there was no need for a lengthy trial on the few disputes of fact that might exist.

Argument by Plaintiffs

Plaintiffs asserted that there was a dispute of material fact as to every one of the *Gartenberg* factors.

Beginning with the nature and quality of services provided, the plaintiffs argued that the evidence showed that substantially all advisory services were delegated to the sub-adviser, and day-to-day administration of the fund was delegated to a sub-administrator. Various other services provided were allegedly either only provided for a discrete period in time or insufficient to justify the amount of fees charged. With regard to the quality of services, the plaintiffs asserted that performance is the most important indicia of the quality of services, and nine of the twelve funds performed worse than their fund comparison groups.

Regarding profits realized by the adviser, the plaintiffs stated that although the existence of profits is undisputed, the profit margin is disputed. Furthermore, the plaintiffs' expert asserted that FMG's practice of charging the Sivolella Funds for "AXA allocated costs" was improper and was in compensation for allegedly duplicative services, creating yet another issue of material fact. The plaintiffs' expert also disputed the validity of the fee comparisons considered by the Board, and asserted that the appropriate comparison should be between fees and costs. Notably, the plaintiffs did not present argument on economies of scale.

Moving to fall-out benefits, the plaintiffs asserted that various benefits enjoyed by AXA resulted from AXA's relationship with the Sivolella Funds. Regarding Board process, the plaintiffs pointed out that their expert

had found the Board's process to be "abysmal." The plaintiffs asserted the Board was not fully informed because it had not been given information valuing the fall-out benefits accruing to the adviser. The plaintiffs also alleged that the Board was not aware of various other agreements that AXA and FMG had to delegate the services provided to the Sivolella Funds. The plaintiffs argued that, as a result, an issue of fact existed as to whether the Board was fully informed.

The District Court's Decision

Very shortly after the conclusion of oral argument, the District Court read from the bench an opinion that appeared to have been previously composed. The District Court began by providing an overview of the law governing claims under section 36(b), including the decisions in *Gartenberg* and *Jones*. The District Court stated that it found issues of material fact with regard to each area of the *Gartenberg* analysis.

With regard to the nature and quality of services, the court indicated that the plaintiffs had alleged that FMG provided *de minimis* services to the Sivolella Funds, whereas the defendants had argued that FMG provided substantial services. The court stated that this disagreement regarding whether services were *de minimis*, or were as argued by FMG, created a "substantial issue of fact."

The court similarly found that because it must consider and evaluate the expert testimony submitted by both parties regarding performance and comparative fee methodology, denial of summary judgment was required.

With regard to economies of scale, the court recognized that the cost of providing services to a mutual fund does not grow in proportion to the size of the fund, such that fees must be reduced as assets under management increase. The plaintiffs submitted that the defendants had failed to pass along economies of scale; the defendants alleged that the plaintiffs had failed to prove the existence of economies of scale, and that section 36(b) does not require an adviser to pass on *all* the benefits of economies of scale. The court found this dispute to present a "clear question of material fact" that could not be determined at the summary judgment stage. The dispute over the existence and valuation of fall-out benefits was similarly found to create an issue of fact.

Finally, the court found that an issue of material fact existed as to whether the Board was fully informed and had been provided with sufficient materials to warrant judicial deference to the Board's decision to approve the advisory agreement. The plaintiffs had alleged that the Board was not provided with material information, including: the amount of fall-out benefits; the proper way to allocate expenses; the fact that the fees paid to the sub-adviser were paid directly by the Sivolella Funds; and various other agreements delegating services provided to such funds.

In light of the number of disputes of material fact, the District Court found that the case was "certainly not subject to summary judgment" and denied the motion.

Conclusion

Plaintiffs show no sign of slowing their increasingly aggressive assault on the mutual fund advisory model. In light of the outcomes in both the *Jones II* and *Sivolella* cases, continued attention should be paid to this evolving field.

Return to main page »

Footnotes

1) 611 Fed. App'x 359 (7th Cir. 2015).

2) No. 3:11-cv-04194 (D.N.J.). On January 22, 2013, a related case *[Sanford v. AXA Equitable Funds Mgt. Group. LLC, No. 3:13-cv-00312 (PGS)]*, which involves the same plaintiffs' and defense counsel and many of the same issues, was consolidated with the *Sivolella* case. For ease of reference, this article refers to the consolidated case as Sivolella.

3) *Gartenberg v. Merrill Lynch Asset Mgt., Inc.,* 694 F.2d 923, 928 (2d Cir. 1982).

4) *Jones v. Harris Associates L.P.,* No. 04 C 8305, 2007 WL 627640, at *9 (N.D. Ill. Feb. 27, 2007), aff'd on other grounds, 527 F.3d 627 (7th Cir. 2008), *vacated and remanded*, 559 U.S. 335 (2010), *aff'd,* 611 Fed. App'x 359 (7th Cir. 2015).

5) *Jones v. Harris Associates L.P.,* 527 F.3d 627 (7th Cir. 2008), *vacated and remanded,* 559 U.S. 335 (2010), *and aff'd,* 611 Fed. App'x 359 (7th Cir. 2015).

6) 611 Fed. App'x 359 (7th Cir. 2015). Because one of the members on the original argument panel, Judge Terence Evans, had passed away between the time the case was remanded from the Supreme Court and the issuance of the Seventh Circuit's decision, the case was decided by a quorum of Judge Frank Easterbrook, the author of the original Seventh Circuit *Jones* opinion that was reversed by the Supreme Court, and Judge Michael Kanne.

This update was authored by:

David A. Kotler
Partner
T: +609 955 3226
david.kotler@dechert.com

Catherine Wigglesworth
Associate
T: +215 994 2432
catherine.wigglesworth@dechert.com

dechert.com

K&L GATES

LEGAL INSIGHT

25 August 2015

Practice Groups:

Securities and Transactional Litigation

Investment Management, Hedge Funds and Alternative Investments

Global Government Solutions

Seventh Circuit Affirms District Court on Remand in *Jones v. Harris Associates*

By Molly K. McGinley

In *Jones v. Harris Associates L.P.*, the Supreme Court adopted the *Gartenberg* standard for cases brought under Section 36(b) of the Investment Company Act of 1940: "[T]o face liability…an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The Court remanded the case to the Seventh Circuit to apply this standard in the context of an appeal challenging the grant of summary judgement for the defendant investment adviser, Harris Associates L.P. (The Supreme Court's opinion was previously discussed here.) On August 6, 2015, more than five years later, the Seventh Circuit Court affirmed the district court's grant of summary judgment.[1]

On August 20, 2015, the plaintiffs filed a petition for rehearing by the Seventh Circuit en banc. In their petition, the plaintiffs claim that the Seventh Circuit's order "persists in pressing a non-conforming interpretation of § 36(b)," which assertedly "conflicts with the Supreme Court's decision in Jones v. Harris Associates L.P., 559 U.S. 335 (2010), and with Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982)." The petition concludes with the assertion that rehearing should be granted because the Seventh Circuit's decision "comes from the pen of one of our most respected and influential jurists" and "will be widely read, cited, and followed if it stands."

A copy of the Petition for Rehearing En Banc is available here.

Background

Section 36(b) of the Investment Company Act ("ICA") imposes upon investment advisers a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by a registered investment company to the investment adviser or any affiliated person of the investment adviser. The same section of the ICA permits a shareholder to bring an action for breach of this duty but, in a significant departure from common law principles, places the burden of proving a breach of fiduciary duty squarely on the shareholder-plaintiff.

In *Jones*, the plaintiffs alleged that fees the adviser charged to the Oakmark Funds were excessive in comparison to fees charged to its institutional clients, and that the fee-approval process essentially had been tainted by the presence of directors who ostensibly were not truly "independent." The district court, applying *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), and finding that the independent directors

[1] As it turned out, the Seventh Circuit had not spent the lengthy interval deliberating. As the Court's opinion acknowledges, due to a misfiling and a gap in the Court's internal system for tracking cases under advisement, the Seventh Circuit lost track of the case. After it discovered the oversight, the Court of Appeals affirmed the district court and corrected the gap in its internal tracking system.

met required independence standards, granted the defendant adviser's motion for summary judgment.

The Seventh Circuit affirmed the district court's grant of summary judgment, but disapproved of *Gartenberg*. Circuit Judge Easterbrook wrote for a three-judge panel of the Seventh Circuit that as long as a fiduciary, such as a fund adviser, "make[s] full disclosure and play[s] no tricks," the fiduciary generally is free to negotiate its compensation in its own interest, like any other market participant. Observing that the fiduciary duty standard in Section 36(b) "differs from rate regulation," the Seventh Circuit concluded that the statute did not require that advisory fees be "reasonable" in relation to a "judicially created standard" like that articulated in *Gartenberg*. Although the Seventh Circuit acknowledged that it was "possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for the decision have abdicated" their responsibility, that was not the case where, as in *Jones*, fees "are roughly the same…as those that other funds of similar size and investment goals pay their advisers…."

The Supreme Court's decision resolved the circuit split that was created by the Seventh Circuit's ruling in *Jones*. In its opinion, the Supreme Court concluded that the Second Circuit's 1982 decision in *Gartenberg* "was correct in its basic formulation of what Section 36(b) requires: to face liability under Section 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The Supreme Court vacated the judgment of the Seventh Circuit and remanded the case "for further proceedings consistent with this opinion."

Briefing of the Parties Following Remand

Following the remand of *Jones*, the parties submitted briefing to the Seventh Circuit expressing divergent views as to what course of action the Court of Appeals should take in light of the Supreme Court's decision. The plaintiffs argued that the Seventh Circuit should reverse the district court's denial of their motion for summary judgment on the ground that *Jones* purportedly permits a plaintiff to establish a violation of Section 36(b) based on a Section 15(c) process violation alone. In the alternative, the plaintiffs asked that the Court of Appeals reverse the grant of summary judgment and remand for trial on the plaintiffs' excessive fee claim because the district court assertedly erred in its application of *Gartenberg*. The plaintiffs argued that the district court treated as "dispositive the fact that Harris' fees were not far outside the range that other advisers charged to similar funds," by ostensibly "treat[ing] as immaterial . . . the shareholders' expert and documentary evidence that Harris charged the funds twice what it charged its non-fiduciary clients for 'virtually identical' services," and by "declin[ing] to discount the deference owed to the board's approval of the fees" notwithstanding alleged "procedural irregularities in the fee-setting process…."

Harris Associates argued that the Seventh Circuit could and should affirm the district court's grant of summary judgment for the defendant because the district court correctly applied the *Gartenberg* standard in entering judgment. Harris Associates responded to the plaintiffs' "process violation" argument by pointing out that the language of the Supreme Court's decision in *Jones* focuses on the excessiveness of an advisory fee as the essential condition of a Section 36(b) violation. As to the plaintiffs' alternative argument, Harris Associates' position on remand was that the district court properly applied the *Gartenberg* standard. In

support of the proposition that a disparity in fees alone does not establish a violation of Section 36(b), Harris Associates pointed to, among other things, the Supreme Court's observation that "only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services *in addition to other evidence* that the fee is outside the arm's-length range will trial be appropriate."

Seventh Circuit Decision on Remand

In a four-page order authored by Circuit Judges Easterbrook and Kanne, which was designated a "non-precedential" disposition, the Seventh Circuit affirmed the district court decision granting summary judgment to defendant Harris Associates. The Seventh Circuit concluded that the plaintiffs' "process violation" argument had been presented and rejected on the initial appeal and had been omitted from their petition for certiorari. The Seventh Circuit further clarified, however, that "a process-based failure alone does not constitute an independent violation of §36(b). Instead, we have been instructed that §36(b) 'is sharply focused on the question of whether the fees themselves were excessive'" (citing *Gallus v. Ameriprise Financial, Inc.*, 675 F.3d 1173, 1179 (8th Cir. 2012)).

Turning to the plaintiffs' argument that the district court erred in its application of *Gartenberg*, the Seventh Circuit recognized that "the goal [of Section 36(b)] is to identify the outer bounds of arm's length bargaining and not engage in rate regulation." This means that the Supreme Court's standard is less favorable to the plaintiffs than the one the district court used—yet the plaintiffs lost even under the district court's approach." The Seventh Circuit identified four propositions that it found were not in material dispute, and that it concluded collectively "require[d]" a decision in the defendant's favor:

> [F]irst, Harris's fees were in line with those charged by advisers for other comparable funds; second, Harris provided accurate information to the funds' boards, whose disinterested members approved the fees; third, the fee schedules reduced the applicable percentage charge as funds' assets rose (for example, Harris's fee for one fund was 1% of assets up to $2 billion but 0.75% of assets over $5 billion); fourth, the fees could not be called disproportionate in relation to the value of Harris's work, as the funds' returns (net of fees) exceeded the norm for comparable investment vehicles.

The Seventh Circuit concluded that *satisfying the first and fourth of these propositions alone* would suffice under the Supreme Court's standard. In other words, if an investment adviser's fee is "comparable to that produced by bargaining at other mutual fund complexes" and the evidence shows that the investment adviser "delivered value for money" by performing "as well as, if not better than, comparable funds," the fee is not "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."

The Court also found that the plaintiffs could not avoid this conclusion by comparing the advisory fee charged by Harris Associates' institutional clients to that of its fund clients, absent evidence that would tend to show that "Harris provided pension funds (and other non-public clients) with the same sort of services that it provided to the Oakmark funds, or that it incurred the same costs when serving different types of clients."

Seventh Circuit Affirms District Court on Remand in *Jones v. Harris Associates*

Conclusion

This long-anticipated decision presents an important interpretation of the Supreme Court's opinion in *Jones*, albeit in a "non-precedential" order. Assuming it is the last word in *Jones*,[2] the Seventh Circuit's ruling is a rejection of Section 36(b) claims based solely on allegations of defective process. In addition, while the Supreme Court has cautioned against undue reliance on fees charged by comparable funds sponsored by other advisers, the Seventh Circuit's order highlights the importance of, and interplay between, two *Gartenberg* factors—comparative fees and the nature and quality of services provided—by concluding that where evidence shows that a fee is comparable to other mutual fund complexes and the performance is equal to or better than that of other comparable funds, the fee is not disproportionate. Finally, the decision affirms that a comparison of advisory fees charged to fund and non-fund clients may be rejected altogether where a plaintiff has not established that those clients received the same services or that the investment adviser incurred the same costs in servicing those clients.

Author:

Molly K. McGinley
molly.mcginley@klgates.com
+1.312.807.4419

Additional Contacts:

Jeffrey B. Maletta
jeffrey.maletta@klgates.com
+1.312.807.4419

Stephen J. O'Neil
stephen.oneil@klgates.com
+1.312.807.4217

John W. Rotunno
john.rotunno@klgates.com
+1.312.807.4213

Stephen G. Topetzes
stephen.topetzes@klgates.com
+1.202.778.9328

Nicholas G. Terris
nicholas.terris@klgates.com
+1.202.778.9408

Paul J. Walsen
paul.walsen@klgates.com
+1.312.807.4388

2 According to a recent filing in another Section 36(b) case, *Kenny v. Pac. Investment Mgmt. Co. LLC*, et al., No. 14-cv-01987 (W.D. Wash.), in which one of the firms representing the plaintiff also serves as counsel in *Jones*, the *Jones* plaintiffs intend to file a petition for rehearing en banc.

Seventh Circuit Affirms District Court on Remand in *Jones v. Harris Associates*

K&L GATES

Anchorage Austin Beijing Berlin Boston Brisbane Brussels Charleston Charlotte Chicago Dallas Doha Dubai Fort Worth Frankfurt Harrisburg Hong Kong Houston London Los Angeles Melbourne Miami Milan Moscow Newark New York Orange County Palo Alto Paris Perth Pittsburgh Portland Raleigh Research Triangle Park San Francisco São Paulo Seattle Seoul Shanghai Singapore Spokane Sydney Taipei Tokyo Warsaw Washington, D.C. Wilmington

K&L Gates comprises more than 2,000 lawyers globally who practice in fully integrated offices located on five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants and entrepreneurs in every major industry group as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit www.klgates.com.

October 2015

Ninth Circuit Affirms Dismissal of Excessive Fee Suit

By: Stephen G. Topetzes and Nicole A. Baker

In Turner v. Davis Selected Advisers, LP, the U.S. Court of Appeals for the Ninth Circuit affirmed the judgment of the U.S. District Court for the District of Arizona, dismissing with prejudice the plaintiff's amended complaint brought under Section 36(b) of the Investment Company Act of 1940 (ICA). The Ninth Circuit determined that the plaintiff's allegations respecting the advisory, distribution and shareholder service fees charged to the Fund by its investment adviser and the adviser's affiliated distributor failed to state a claim that the fees were "so disproportionately large that [they bore] no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The Ninth Circuit also affirmed the district court's denial of the plaintiff's motion to alter or amend the judgment and, relatedly, his motion for leave to amend the shareholder's amended complaint.

Background

Pursuant to Section 36(b) of the ICA, investment advisers have a fiduciary duty with respect to the receipt of compensation for services paid by a registered investment company to the investment adviser or any affiliated person of the adviser. Section 36(b) also permits a plaintiff-shareholder to bring an action for breach of this fiduciary duty, but shifts the burden of proof to the plaintiff.

In Jones v. Harris Associates L.P., 559 U.S. 335 (2010), the Supreme Court resolved a circuit split regarding the appropriate standard for evaluating the reasonableness of certain fees charged to a mutual fund. The Court adopted the standard articulated by the U.S. Court of Appeals for the Second Circuit in Gartenberg v. Merrill Lynch Asset Management, Inc. (694 F.2d 923 (2d Cir. 1982)), holding that, in order "to face liability under §36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." In evaluating the reasonableness of the fees at issue, the Jones Court considered the six specific factors identified by the Gartenberg court: (1) the nature and quality of the services provided; (2) the adviser's profit from the fund; (3) the extent to which the adviser realizes economies of scale as the fund grows; (4) "fall-out" benefits received by the adviser; (5) comparison of fees paid by similar funds; and (6) the board's determination of appropriate levels for adviser compensation.

District Court Decision

The Turner plaintiff -- a holder of Class A shares of the Davis New York Venture Fund (Fund) -- brought suit challenging certain fees charged to the Fund by its investment adviser, Davis Selected Advisers, LP (DSA), and the adviser's affiliated broker-dealer/distributor, Davis

Distributors, LLC (DD). In his amended complaint,[1] the plaintiff alleged that the advisory, shareholder service fee and distribution fees charged to the Fund by DSA and DD were excessive and disproportionate in comparison to the services they performed, and constituted a breach of the defendants' fiduciary duties under Section 36(b).

The U.S. District Court for the District of Arizona dismissed with prejudice the plaintiff's amended complaint, finding that, although the amended complaint sufficiently articulated the Gartenberg factors, "[p]laintiff's allegations largely consist[ed] of general conclusions, not facts, and [p]laintiff [did] not explain how any of the facts alleged show that a particular fee" was excessive in proportion to the services rendered. In doing so, however, the district court also determined that Turner --a Class A shareholder -- had standing to seek to assert claims respecting all of the Fund's share classes.

Turner subsequently filed a motion to amend the district court's judgment, and requested leave to file a second amended complaint. After extensive briefing, the district court denied the plaintiff's motion(s). The district court found that the plaintiff "had sufficient opportunity to submit a further amended complaint, with additional factual allegations based on evidence readily available, prior to the Court's dispositive ruling and in light of the parties' extensive briefing." The court reiterated that Turner had not "set forth sufficient reasons for allowing the extraordinary remedy of reopening the judgment and permitting an amended complaint to be filed."

Ninth Circuit Decision

Turner appealed the district court's decision to the U.S. Court of Appeals for the Ninth Circuit, arguing that DSA and DD breached their fiduciary duties by charging excessive fees to the Fund. With respect to advisory fees, Turner asserted that the: (a) "[a]dviser provided fewer services compared to other actively managed funds; (b) Fund materially underperformed its peer funds and indices; (c) [a]dviser charged advisory fees that were materially out of proportion to the lesser services and inferior performance it provided, and to fees charged to comparable funds; and (d) despite the Fund's enormous size, [DSA and DD] returned immaterial economies of scale to the Fund." Turner also alleged that DSA and DD breached their fiduciary duties under ICA §36(b) by receiving unlawful 12b-1 fees, where: (a) DSA and DD "received hundreds of millions of dollars of 12b-1 fees annually; (b) the Fund's enormous and increasing size and 12b-1 fees were a material cause for its underperformance of comparable peer funds/indices; and (c) the Fund paid 12b-1 fees for post-sale shareholder services that were not 'primarily intended' to sell Fund shares."

The parties briefed the relevant issues, and oral argument was held on June 10, 2015. In an order authored by Circuit Judges Hawkins and Watford, and Jed S. Rakoff, Senior District Judge for the U.S. District Court for the Southern District of New York (sitting by designation), the Ninth Circuit affirmed the judgment of the district court dismissing with prejudice the plaintiff's amended complaint, as well as the lower court's denial of his motion to alter or amend the judgment.

Relying on Jones, the Ninth Circuit noted that, "a court's evaluation of an investment adviser's fiduciary duty must take into account both procedure and substance." Jones at 351. In that connection, the Ninth Circuit observed that a court will accord deference to a

[1] DSA and DD moved to dismiss the plaintiff's initial complaint. Turner filed an amended complaint before the district court ruled on the pending motion.

mutual fund's board of directors respecting fees charged to the fund depending on the strength of the board's process for reviewing the agreement. The Ninth Circuit held that, in Turner, the board's process was not deficient.

The Ninth Circuit further determined that "the majority of Turner's allegations" concerning the advisory fee were "grounded in inapt comparisons," and that "to pursue a §36(b) claim, allegations pertaining to a fund's performance must use mutual funds pursuing similar investment strategies as comparators." The Ninth Circuit declined to consider plaintiff's comparison to fees charged by index funds, noting that the Fund is actively managed. Similarly, the Ninth Circuit found that Turner's comparison to the "fee extracted from other mutual funds" did not support his claims because he "failed to allege that these other funds' advisers provided the same services or pursued a similar investment strategy." The Ninth Circuit also noted that, with respect to the plaintiff's allegation that DSA failed to pass along economies of scale to the Fund's shareholders, Turner failed to "assert that the amount of time and money that DSA spent performing research remained the same as the [F]und increased in size, but only that the cost of researching a 'particular investment in a particular stock' stayed flat." The Ninth Circuit further stated that Turner failed to identify what percentage of DSA's work was spent researching specific investments.

The appellate court did not credit Turner's arguments with respect to the shareholder service fee. Among other things, the Ninth Circuit found that "an increase in advisory and transfer fees will always be a byproduct of fees used to grow a mutual fund," and do not constitute "fall-out" benefits. Also, "[a] legal obligation to perform certain services . . . is not an obligation to perform those services for free;" a fee paid for such services is not per se excessive.

The plaintiff's allegations with respect to the distribution fee were similarly unavailing. Rejecting the district court's reasoning, the Ninth Circuit held that the plaintiff, who owned Class A shares of the Fund, did not suffer any injury from the allegedly excessive distribution fee charged to Class B, C and R shareholders. The Ninth Circuit noted that, although "the Amended Complaint asserts that the distribution fee is 'in effect' paid out of the Fund's assets, it never alleges that . . . the distribution fee itself lowered the value of Class A shares or that it deprived Class A shares of growth from a missed investment."

Finally, the Ninth Circuit affirmed the district court's denial of the plaintiff's motion to amend the judgment and to file a second amended complaint.

Conclusion

The Turner decision is significant for several reasons. Perhaps most importantly, Turner is unique in that it is the first decision since the Supreme Court decided Jones in which a court has dismissed claims asserted under Section 36(b) at the initial pleadings stage. Other courts have denied motions to dismiss and allowed excessive fee cases to proceed to (time-consuming and expensive) discovery. Turner also is significant in that, unlike some other courts, the Ninth Circuit rejected the view that the plaintiff (a shareholder of one share class) had standing to bring suit on behalf of other share classes; the Turner court reasoned that, although each share class participates in the same portfolio of assets, the plaintiff had not been injured by the allegedly excessive distribution fee charged to Class B, C and R shareholders.

Ninth Circuit Affirms Dismissal of Excessive Fee Suit

Authors:

Stephen G. Topetzes
stephen.topetzes@klgates.com
+1.202.778.9328

Nicole A. Baker
nicole.baker@klgates.com
+1.202.778.9018

SESSION 1-C: Making Sense of Equity Market Structure: Complexities and Conflicts

Jennifer S. Choi, Moderator
Investment Company Institute

Kevin Cronin
Invesco

Daniel M. Gray
U.S. Securities and Exchange Commission

Annette L. Nazareth
Davis Polk & Wardwell LLP

Ira P. Shapiro
BlackRock

Agenda

- Introduction
- Market Volatility
  - Overview of Events on August 24, 2015
  - Market Volatility Mechanisms
  - Effects on ETFs
  - Market Structure Improvements or Changes Needed
- Technology Challenges – Single Points of Failure
  - NYSE Trading Halt on July 8, 2015
  - Securities Information Processor ("SIP") Issues
- Order Routing and Venue Analysis
  - Best Execution and Funds' Use of Analysis
  - Order Routing Disclosures for Institutional Investors
  - Proposed Amendments to Regulation ATS
  - Maker-Taker Fee Model
  - MiFID II Best Execution

Market Volatility

Overview of Events on August 24, 2015

- U.S. equity markets and equity-related futures markets experienced unusual price volatility on August 24th.
- Even before the opening of regular trading hours on the equity markets, the most active exchange-traded products ("ETPs") and futures products reflected substantial declines in the broad market indices.
  - By 9:30, the SPDR S&P 500 ETF Trust, ("SPY") the most actively traded equity product, was down more than 5%.
  - By 9:35, SPY declined to a daily low of 7.8%.
  - The most actively traded equity-related futures contract, the E-Mini S&P 500, declined to its limit down price of 5% below the previous trading day's closing price.
  - From 9:30 to 9:45, more than 20% of the S&P 500 companies and more than 40% of the NASDAQ-100 companies reached daily lows that were 10% or more below their previous day's closing price.

Limit Up-Limit Down Mechanism

- In 2012, the SEC approved a Limit-Up-Limit Down ("LULD") mechanism submitted by FINRA and the exchanges to address market volatility by preventing trades in listed equity securities when triggered by large, sudden price moves in an individual stock.
- LULD is intended to prevent trades from occurring outside of a specified price band, which is based on a reference price that equals the arithmetic mean price of the stock over the immediately preceding five-minute trading period.
  - The price limit bands during regular trading hours are 5%, 10%, 20%, or the lesser of $.15 or 75%, depending on the price of the stock.
  - These price bands double during the opening and closing periods of the trading day.
- If the price of the stock does not naturally move back within the price bands within 15 seconds, there will be a five-minute trade pause.

Limit Up-Limit Down Mechanism *(cont'd)*

Limit Up-Limit Down Mechanism on August 24th

- On August 24th, there were over 1200 LULD trading halts, most of which occurred in ETPs.
  - 80% of ETPs did not experience a LULD halt.
  - Less than 2% of the components of the S&P 500 and NASDAQ 100 indices triggered halts.
  - More than half of the impacted securities triggered more than one halt and a quarter of the impacted securities were halted 4 or more times.

Clearly Erroneous Trades

- On the day of the 2010 Flash Crash, the exchanges broke trades in a manner that was criticized by many as being arbitrary and lacking transparency.
- "Clearly erroneous" trades deviate substantially from current market prices.
- Following the Flash Crash, the exchanges and FINRA adopted rules for nullifying "clearly erroneous" trades and adopted specified percentage thresholds and standards at which trades will be broken.
- Few trades on August 24th were broken under the clearly erroneous rules of the exchanges.

Market-wide Circuit Breakers

- Circuit Breakers are rules that limit trading activity upon the occurrence of a specified event.
  - Market-wide Circuit Breakers halt trading in all exchange-listed securities throughout U.S. markets.
- The exchanges and FINRA have rules in place for specified market-wide trading halts following certain levels of market decline.
- The length of the halt will depend on the time of day that the halt is triggered.
- Market-wide Circuit Breakers did not halt trading on August 24th.
  - Might have triggered a halt had it followed the NAV of the S&P 500.

Effects on ETFs

ETF Arbitrage Trades Counter Market Trend, Supply Liquidity, Help Balance Supply/Demand

11 AM

- ETF Share Price > Basket Cost
- AP1 Sells ETF Shares Short, Acquires Basket[1] (Opens Hedged Position)
- Creates ETF Shares, Delivers Basket at Close
- T+3: Receives ETF Shares (Settlement of Creation), Delivers to Close Short Sale
- Profit = 0.08 per Share

2 PM

- ETF Share Price < Basket Proceeds
- AP2 Buys ETF Shares, Sells Basket Short[1] (Opens Hedged Position)
- Redeems ETF Shares at Close
- T+3: Receives Basket from ETF (Settlement of Redeem), Delivers to Close Short Sale
- Profit = 0.10 per Share

[1] More realistically, AP1 would probably acquire a long futures contract to hedge the short sale of ETF shares and borrow the basket to create ETF shares, and AP2 would acquire a short futures contract to hedge its long position in ETF shares.

Market Structure Improvements or Changes Needed

Key Highlights from the SEC Staff's December 2015 "Research Note" on the equity market volatility on August 24, 2015

- Corporate stocks with the largest capitalization were particularly affected on August 24th.
- The largest capitalization ETPs experienced declines that were similar to those of smaller ETPs.
- ETPs as a class experienced more substantial increases in volume and more severe volatility than corporates.
- Regulation SHO short sales restrictions were triggered in more than 2,000 securities.

Market Structure Improvements or Changes Needed *(cont'd)*

- Areas where the SEC staff will continue to examine issues related to August 24th:
  - the nature of selling pressure, sources of liquidity provision, and the create and redeem activity for ETPs;
  - the effect of Regulation SHO short sales restrictions;
  - the opening process on primary listing exchanges;
  - the reopening process following LULD halts;
  - the operation of the LULD plan; and
  - the operation of Market-wide Circuit Breakers.

Technology Challenges – Single Points of Failure

NYSE Trading Halt of July 8, 2015

- NYSE halted trading on the NYSE and NYSE MKT for 3.5 hours on July 8th due to technical issues.
  - Issues stemmed from the rollout of a software release in preparation for the industry test of the SIP timestamp.
  - NYSE Arca, Arca Options and NYSE AMEX Options were not impacted.
- Nasdaq and BATS picked up the runoff.
- SEC Chair Mary Jo White issued a public statement that the SEC was "in contact with NYSE and [was] closely monitoring the situation and trading in NYSE-listed stocks."

Securities Information Processor ("SIP") Issues

- Background
  - The SIP links U.S. markets by processing and consolidating all protected bid/ask quotes and trades from every trading venue into a single data feed.
  - The SIP disseminates and calculates critical regulatory information including the National Best Bid and Offer ("NBBO") and Limit Up Limit Down price bands, among other information.
- Potential Issues
  - Latency Arbitrage – Private data feeds do not go through extra step of consolidation at the SIPs and can reach end-users faster than the consolidated data feeds.
  - Single Point of Failure – Although markets are fragmented, U.S. trading venues rely on only two SIPs – the NYSE SIP and the NASDAQ SIP.

Order Routing and Venue Analysis

Best Execution and Funds' Use of Analysis

- Broker-Dealer Duty of Best Execution – Based, in part, on the common law agency duty of loyalty.
- Explicitly incorporated in FINRA Rule 5310
  - "In any transaction for or with a customer or a customer of another broker-dealer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions."
- Funds' Use of Analysis

Order Routing Disclosures for Institutional Investors

- Current Disclosure Practices
  - Publically-available order routing and execution quality statistics are available pursuant to Rules 605 and 606 of Regulation NMS and through ad hoc reports prepared in response to requests.
  - Reports do not provide information to measure broker-dealers' and execution venues' performance with respect to specific institutional investors.
  - Reports are not presented in a uniform manner that allows for easy comparison.
- ICI/SIFMA/MFA Proposed Solution: Order Routing Disclosure Template
  - Standardized template that contains the minimum disclosure of order routing and execution quality information that institutional investors could request from their broker-dealers.
- Potential SEC Action
  - Chair White has asked SEC staff to prepare a recommendation to the Commission for a rule that would enhance order routing disclosures.

Proposed Amendments to Regulation ATS

- New Operational Transparency Requirements. Proposal would require alternative trading systems that facilitate transactions in NMS stocks ("NMS Stock ATSs") to publicly disclose detailed information about the activities of their broker-dealer operators (and their affiliates) and the operations of the ATSs themselves on new Form ATS-N, which must be approved by the SEC.
  - Form ATS-N would require extensive disclosures, including, among other things:
    - any arrangements with unaffiliated trading centers (e.g., preferential routing arrangements or mutual access arrangements);
    - information about the use of smart order routers and algorithms to send or receive subscriber orders; and
    - differences in the availability of services, functionalities, or procedures to subscribers and the availability of those services, functionalities, or procedures to the broker-dealer operator or its affiliates.
- New Written Policies and Procedures. Proposal would require written policies and procedures to safeguard confidential data.
- Potential Expansion of Proposal. Among other things, the SEC sought comment on whether the SEC should require similar levels of transparency for ATSs that only trade in government securities or other securities that are not NMS stocks.

Maker-Taker Fee Model

- In general
  - Market participant providing a resting liquidity-providing order (the "maker") receives a rebate upon execution.
  - Market participant that executes the resting order (the "taker") pays a fee for accessing that liquidity.
- Potential Advantages
  - Some believe it is an important competitive tool for exchanges leading, directly or indirectly, to better prices for retail investors.
- Potential Disadvantages
  - Some believe it may exacerbate conflicts of interest, contribute to market fragmentation and market complexity through the proliferation of order types, and undermine price transparency.
- Pilot Programs
  - Market participants have called for a pilot project to study the effects of eliminating maker-taker pricing.

MiFID II Best Execution

- Markets in Financial Instruments Directive II ("**MiFID II**") - legislation dealing with various trading and markets issues in the EU.
  - Compliance likely required by January 2018.
- Best Execution Obligations
  - For each of 22 classes of financial instruments, fund managers will have to disclose, among other things:
    - top five brokers by trading volumes;
    - how venue/broker selection occurs;
    - Processes used to analyze quality of execution;
    - Procedures for monitoring and verifying best possible results were obtained.
- Information from Brokers
  - Fund managers will also receive an increase in information from brokers, including information about the top five venues to which orders are routed.

How ETFs Work

Purchases and redemptions are generally effected on an in-kind basis through deposit with or transfer from the ETF of a specified basket of securities.

Purchases and redemptions of ETF shares may only be effected in large blocks by or through Authorized Participants (APs).

The ability of APs to continually adjust the supply of shares by purchasing and redeeming shares of the ETF at NAV per share allows the market to maintain a supply/demand balance. This so-called "arbitrage mechanism" tends to ensure that ETFs trade at or close to fair value.

- **To support the arbitrage process a variety of information is disseminated to the marketplace.**
  - ETF portfolio holdings (or, in some cases, a subset of holdings) are disclosed on a daily basis.

ETF Market Mechanics

Because ETFs trade in the market like other stocks, they benefit shareholders by:

- Enabling trades any time during market hours
- Enabling equity technique usage—limit orders, short sales, margin—generally not available with conventional mutual funds
- Developing secondary market liquidity in addition to inherent liquidity from underlying portfolio

The ETF creation/redemption mechanism allows institutional market participants to adjust the supply of shares in the market in response to changes in demand.

- "arbitrage mechanism" keeps market prices close to the underlying portfolio value.

For the "arbitrage mechanism" to work an ETF must have:

"***Valuation Clarity***"

- a mechanism that permits APs to assess an ETF's underlying value to a reasonable degree of accuracy in real time during trading hours
- Existing U.S. ETFs achieve this through transparency of creation/redemption baskets or full portfolio

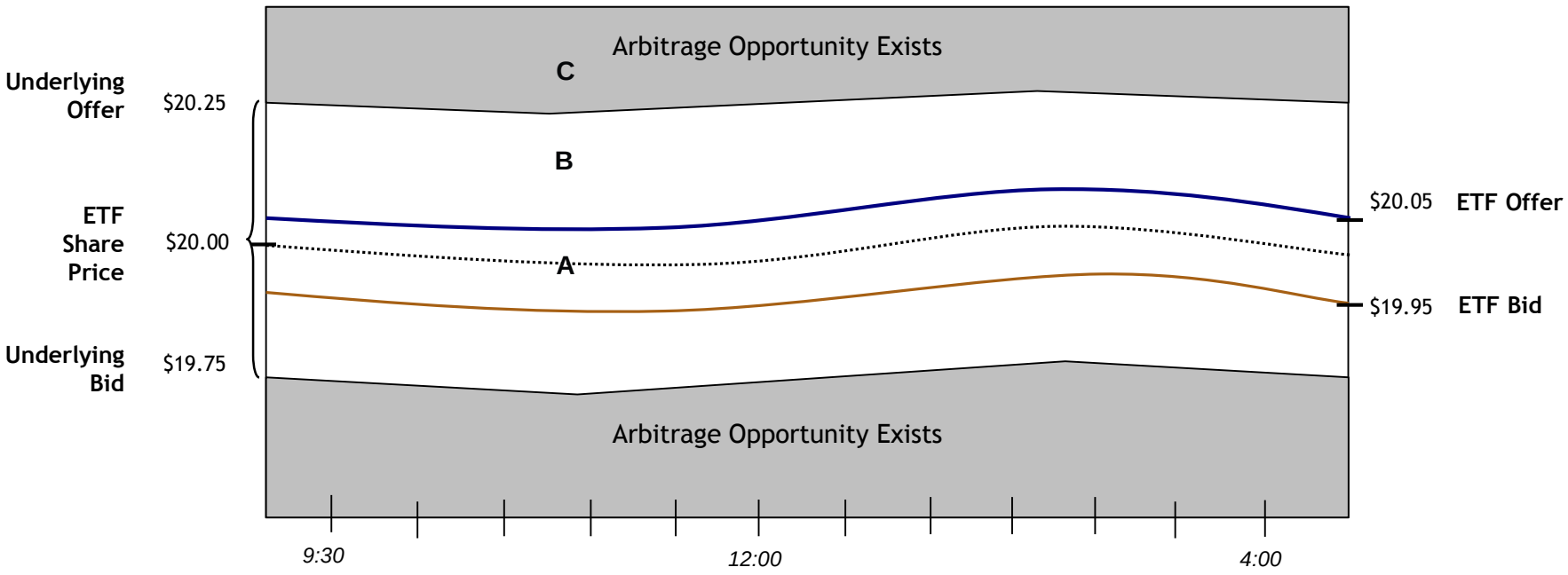
"***Access***"

- the ability of market participants to provide liquidity through arbitrage trading when discrepancies between an ETF's underlying value and the price of its shares on the exchange occur
- In primary market, requires APs to be able to acquire basket securities needed for creation (necessary for market maker to create inventory of ETF shares with which to meet market demand when secondary market is strong)
- In secondary market, requires the ability to create workable hedges for ETF shares (necessary for market maker to acquire and maintain inventory of ETF shares when secondary market demand is weak)

Who Arbitrages ETFs?

- Designated Market Makers – appointed by exchange and subject to exchange rules requiring two-way quotations, but do not have a monopoly on trading
- Informal Market Makers – behave similarly but not subject to exchange rules, can cease making markets at any time
- HFTs, Hedge Funds – proprietary traders, not required to maintain two-way quotations

When Does an ETF Arbitrage Opportunity Exist?

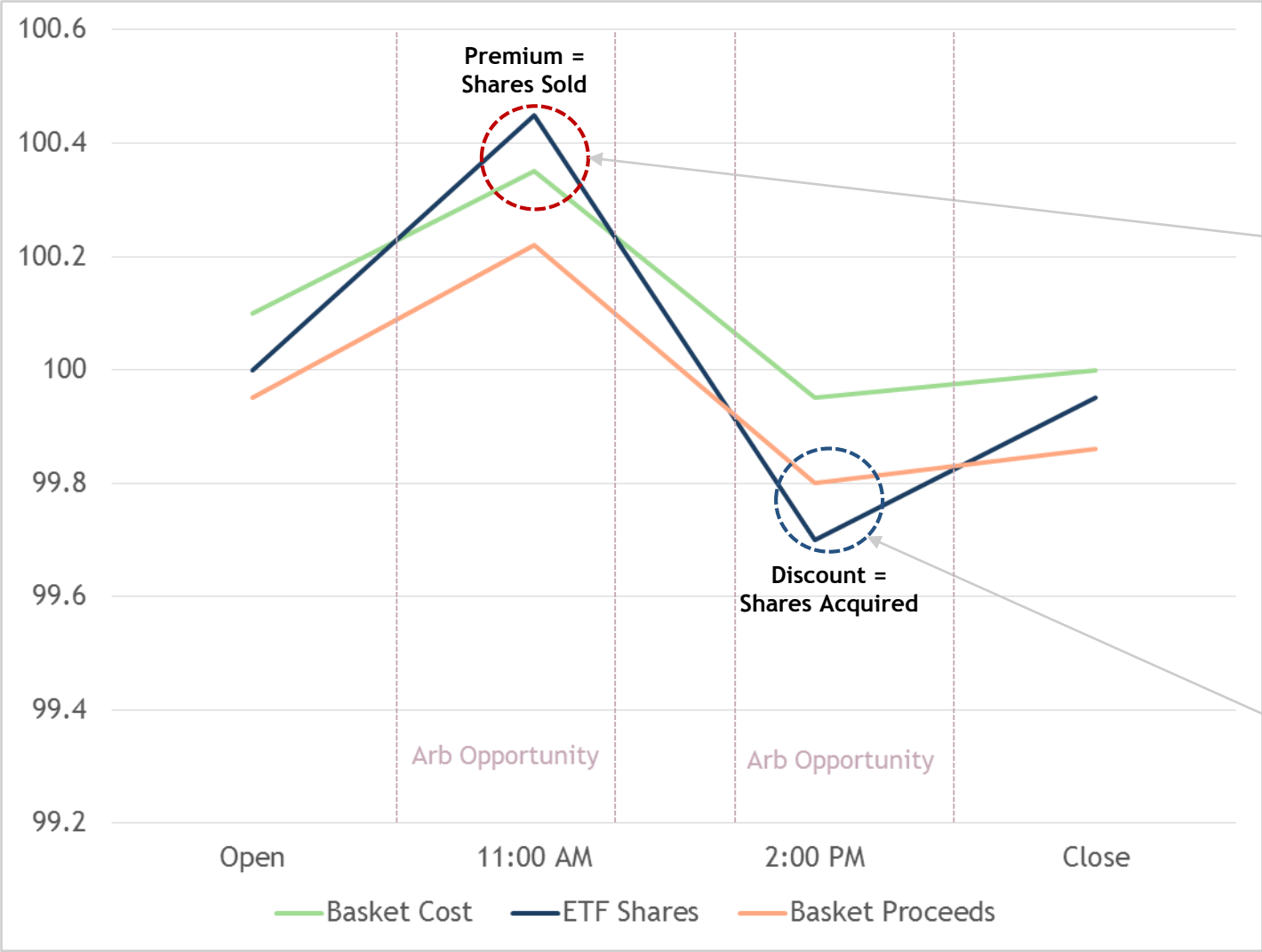


- Point A – Executed within the ETF quote (supply and demand match)
- Point B - Executed outside ETF quote, but still cheaper than underlying basket (excess demand for ETF shares leads to slight premium, but ETF shares are less expensive to purchase than direct purchase of its holdings)
- Point C – Executed outside underlying quote and arbitrage opportunity exists (opportunity to sell ETF shares short and purchase its holdings at an arbitrage profit, supplying liquidity to diminish premium)

ETFs frequently offer investors a price better than they could otherwise transact in the underlying basket

How Does an ETF Arbitrage Work? (Simple Example)

ETF Arbitrage Trades Counter Market Trend, Supply Liquidity, Help Balance Supply/Demand



11 AM

- ETF Share Price > Basket Cost
- AP1 Sells ETF Shares Short, Acquires Basket[1] (Opens Hedged Position)
- Creates ETF Shares, Delivers Basket at Close
- T+3: Receives ETF Shares (Settlement of Creation), Delivers to Close Short Sale
- Profit = 0.08 per Share

2 PM

- ETF Share Price < Basket Proceeds
- AP2 Buys ETF Shares, Sells Basket Short[1] (Opens Hedged Position)
- Redeems ETF Shares at Close
- T+3: Receives Basket from ETF (Settlement of Redeem), Delivers to Close Short Sale
- Profit = 0.10 per Share

1. More realistically, AP1 would probably acquire a long futures contract to hedge the short sale of ETF shares and borrow the basket to create ETF shares, and AP2 would acquire a short futures contract to hedge its long position in ETF shares.

Reasons ETF Arbitrage May Fail Temporarily During Extreme Volatility

Some ETFs are bought and sold mostly by retail investors, not institutions. These ETFs often have less deep two-way markets and are more vulnerable to huge sell imbalances during market volatility

- Use of "stop loss" orders by retail investors may be contributing factor

"***Valuation Clarity***" may fail due to:

- Extreme market volatility leads to trading halts in underlying securities
- Market structure glitches that limit transparency into the order book/likely prices for underlying securities not trading
  - Automated pre-open imbalance information is provided until 9:40, when stocks are expected to have opened, but on August 24 a significant portion of U.S. stocks had not yet when the imbalance information shut off

"***Access***" may fail due to:

- Inability to hedge purchases of ETF shares (underlying securities not trading, futures trading halts)
- Risk of hedging rises due to market uncertainty
  - "Erroneous trade" guidelines may lead to trade cancellations during extreme market turbulence, potentially leaving one side of a hedge exposed to unhedged risk if the other side of trade is executed at an "erroneous" price

Most ETF arbitrage trading is ***computer-driven***

- Computer-driven trading is often programmed to halt automatically if
  - A specified portion of data feeds are unavailable (even if the data is, arguably, not critical)
  - Hedge instruments are not available for arbitrage (e.g., the computer may be programmed to look at pricing discrepancies between an ETF's shares and S&P 500 futures, but not between an ETF's shares and SPY)
  - Overall volatility and pricing moves in the ETF's underlying portfolio triggers an algorhythmic determination that risk is so abnormally high that it outweighs potential arbitrage profits
- Once shut down, computer-driven arbitrage trading may be difficult to reestablish quickly
  - Human traders with override capabilities may be responsible for following a large number of securities, making instantaneous corrective decisions in any one of the securities impracticable
  - Trade programming cannot be reprogrammed in real time
  - Even after-the-fact, the cost of reprogramming may outweigh the benefits for thinly-traded ETFs

Current Market Structure Issues in the U.S. Equity and Options Markets

2016 Mutual Funds and Investment Management Conference

Making Sense of Equity Market Structure: Complexities and Conflicts

March 14, 2016

Davis Polk

TABLE OF CONTENTS

CURRENT MARKET STRUCTURE ISSUES IN THE U.S. EQUITY AND OPTIONS MARKETS[1]

I. The Framework of the Equity Trading Markets. The regulatory framework governing the U.S. equity markets was given its current shape by the Securities and Exchange Commission's ("**SEC**") adoption of Regulation ATS in December 1998 and Regulation NMS in June 2005. These regulations revised and codified a series of rules adopted by the SEC in the years surrounding the enactment of the Securities Act Amendments of 1975. The regulations also built on a structure of self-regulatory organization ("**SRO**") rules, including rules of the exchanges and the Financial Industry Regulatory Authority, Inc. ("**FINRA**"), which was formed in 2007 through the merger of the National Association of Securities Dealers, Inc. ("**NASD**"), and the member regulation functions of the New York Stock Exchange ("**NYSE**"). As the equity markets evolve and new issues are identified, the SEC has responded by adopting additional rules and regulations that have reinforced aspects of the framework created by Regulation ATS and Regulation NMS, including: (1) Regulation SHO in 2004; (2) Rule 15c3-5, the market access rule, in 2010; and (3) Regulation SCI in 2014.

A. Regulation ATS. The SEC adopted Regulation ATS and accompanying Rule 3b-16 to update the scheme of exchange regulation devised by Congress in 1934 in an era in which order interaction and price discovery functions were best fulfilled by trading on physical exchange floors. Exchange Act Release No. 40760 (Dec. 8, 1998) (adopting Regulation ATS and Rule 3b-16) (the "**Regulation ATS Adopting Release**").

1. Exchange Regulation. The Securities Exchange Act of 1934 (the "**Exchange Act**") codified the then prevalent system of exchanges operating as membership organizations that established trading rules and imposed broker-dealer capital, business conduct and fixed commission requirements as a condition of membership.

(a) Section 3(a)(1) of the Exchange Act broadly defines the term "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a marketplace or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the marketplace or market facilities maintained by such exchange."

(b) Section 5 of the Exchange Act requires exchanges to register with the SEC, and Section 6 of the Exchange Act requires a registered exchange to operate as an SRO with rulemaking and disciplinary authority over its members.

[1] Prepared by Annette Nazareth, Partner, Zachary Zweihorn, Counsel, and Jeffrey Dinwoodie, Meghan King and Mark Sater, Associates, Davis Polk & Wardwell LLP. Last updated February 29, 2016.

(c) Because of their self-regulatory role, exchanges are required pursuant to Section 6 and Section 19 (as revised in 1975) to act by formal rule, to not unreasonably discriminate in admitting new members and to follow fair disciplinary procedures in actions against members. Exchanges are also required to provide members with fair representation in the governance of the exchange and to equitably allocate reasonable dues, fees and other charges among its members.

2. Development of Proprietary Trading Systems. The growing availability of widespread, inexpensive automation and electronic communication systems gave rise to electronic trading systems that challenged the dominance of the floor-based exchange trading model. As a result, beginning in the 1970s, exchanges began automating some of their order delivery and execution systems, the NASD developed the NASDAQ electronic quotation system for over-the-counter ("**OTC**") stocks and broker-dealers began developing electronic proprietary trading systems.

(a) The proprietary trading systems operated by broker-dealers and others operated on a for-profit basis and sought to avoid being regulated as an exchange.

(b) The SEC staff issued a series of no-action letters to proprietary trading systems. *See, e.g.*, Letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to Daniel Brooks, Cadwalader, Wickersham & Taft, Fed. Sec. L. Rep. CCH 78,997 1986 WL 67657 (SEC) (Sept. 8, 1986). In 1994, the SEC adopted a recordkeeping and reporting rule for these systems. Exchange Act Release No. 35124 (Dec. 20, 1994).

3. Regulation of Alternative Trading Systems. In 1998, the SEC adopted Rule 3b-16 to define which automated trading systems were exchanges, and Regulation ATS to exempt certain automated trading systems from registration as an exchange, subject to conditions that applied the core elements of exchange regulation to exempted "alternative trading systems" (sometimes referred to in this outline as "**ATSs**"). *See* the Regulation ATS Adopting Release.

(a) Regulation ATS contains conditions that need to be satisfied to be exempt from the requirement to register as an exchange under Section 6 of the Exchange Act:

(1) **Broker-Dealer Status**. Rule 301(b)(1) of Regulation ATS requires that the ATS be registered as a broker-dealer under Section 15 of the Exchange Act or be operated by a registered broker-dealer.

(2) **No SRO Powers**. Rule 300(a) makes clear that an ATS cannot exercise self-regulatory powers, such as regulating its members' or subscribers' conduct when engaged in activities outside of that trading system.

(3) **Name**. Rule 301(b)(11) provides that an ATS cannot use the words "exchange," "stock market" or similar terms in its name.

(4) **Dominance of the Market**. Also, the SEC can determine that a dominant alternative trading system should be registered as an exchange. Rule 3a1-1(b)(1) provides certain bright-line thresholds in this regard: the rule provides that an exchange is not exempt under Rule 3a1-1(a) if during three of the preceding four calendar quarters it had 50 percent or more of the average daily dollar trading volume in any security and five percent or more in any class of security, or 40 percent or more of the average dollar trading volume in any class of securities and the SEC after notice has determined that the exemption is not appropriate.

(b) The core exchange elements that are applicable to ATSs include:

(1) **SEC Registration and Reporting**. Rule 301(b) requires an ATS to register with the SEC using Form ATS and to undertake certain ongoing notice and reporting obligations.

(i) *See* Section II.D.3(c) for a discussion of a recent SEC proposal that would require ATSs that facilitate transactions in NMS stocks to file, and obtain SEC approval of, a new Form ATS-N, which would require extensive new disclosures.

(2) **Order Display and Execution Access**. Rule 301(b)(3)(ii) provides that, with respect to any NMS stock in which the ATS during at least four of the preceding six calendar months had an average daily trading volume of five percent or more of the aggregate average daily share volume, the ATS shall provide to a national security exchange or association the prices and sizes of the orders at the highest buy price and the lowest sell price for such NMS stock displayed to more than one person in the ATS (other than employees), for inclusion in the quotation data published by the exchange or association.

(i) With respect to any order displayed pursuant to Rule 301(b)(3)(ii), the ATS displaying the order shall provide to any broker-dealer that has access to the national securities exchange or association to which the ATS provides the prices and sizes of displayed orders the ability to effect a transaction with such orders that is equivalent to the ability of such broker-dealer to effect a transaction with other orders displayed on the exchange or by the association, and at the price of the highest priced buy order or the lowest priced sell order displayed for the lesser of the cumulative size of such priced orders entered

therein at such price, or the size of the execution sought by such broker-dealer.

(ii) *See* Section II.D.1(a)(2) for a discussion of the SEC's November 2009 proposal to amend Regulation ATS to lower the volume threshold that triggers order display and execution access requirements.

(3) **Fair Access**. Rule 301(b)(5) requires an ATS to provide fair access to its system with respect to any security that the ATS had five percent or more of the average daily volume in that security for at least four of the six preceding calendar months.

(i) Rule 301(b)(5)(iii) contains an exception for passively priced alternative trading systems that match customers' orders for a security with other customer orders, provided that such customers' orders are not displayed to any person (other than employees), and such orders are executed at a price for such security disseminated by an effective transaction reporting plan, or derived from such prices.

(ii) The fair access requirement is more expansive than the requirement that access is provided to a specific displayed quote, as access into a system would provide access to enter limit orders, view the depth of book in a given security and participate in any unique order features offered by the ATS.

(4) **Capacity, Integrity and Security of Automated Systems**. Rule 301(b)(6) requires the computer systems of an ATS to be periodically tested and reviewed for reliability and for the ATS to develop disaster recovery plans, if during at least four of the six preceding calendar months the ATS reaches 20 percent of average daily trading volume.

4. Electronic Communication Networks. As of the second quarter of 2012, Regulation ATS facilitated the development and registration of approximately 90 trading systems, 45 of which actively trade NMS stocks, including three entities acting as Electronic Communication Networks ("**ECNs**")—which are ATSs that make their quotes available electronically to the public. *See* Laura Tuttle, SEC Division of Economic and Risk Analysis, *Alternative Trading Systems: Description of ATS Trading in National Market System Stocks* (Oct. 2013).

B. Regulation NMS. The SEC adopted Regulation NMS in June 2005 to address a combination of issues arising under the national market system rules and plans that had been adopted pursuant to the 1975 Amendments. *See* Exchange Act Release No. 51808 (June 9, 2005) (the "**Regulation NMS Adopting Release**").

1. Issues Pre-Regulation NMS. Changing market conditions put pressure on the market structure rules developed primarily in the 1970s.

(a) Increasingly, trading of securities spread across many markets ("**fragmentation**"), and retail customer orders were executed internally by market makers and trading systems without exposure of these orders to other traders ("**internalization**"). These developments raised concerns that the pricing function of the market could be impaired, as customer limit orders displayed in one market were ignored while trades for other customers received worse execution.

(b) The SEC in 2000, under pressure from Congress, required the SROs to move to decimal pricing of trading systems. *See* Exchange Act Release Nos. 42914 (June 8, 2000), 42685 (Apr. 13, 2000) and 42360 (Jan. 28, 2000).

(1) Decimalization resulted in quoting and trading equities in pennies, rather than in eighths or sixteenths of a dollar.

(2) Decimalization reduced quote spreads and improved retail execution prices, but also reduced the size of displayed quotes and raised concerns regarding reduced liquidity.

(3) Decimalization also facilitated trading in sub-penny increments.

(c) The development of electronic markets and the spread of automated executions and order routing created tensions with floor-based markets where much of the order execution process was still manual, and for the Intermarket Trading System (the "**ITS**"), which was an SRO-operated order routing system that linked the exchanges and the OTC market in listed securities.

(1) The SRO plan governing the ITS prohibited participant exchanges and OTC market makers from trading at prices inferior to the displayed quote of a participant market (*i.e.*, "trading through" the quotes), unless the participant that traded-through the displayed quote routed a commitment to the participant market whose quote was traded-through and gave that participant at least 30 seconds to respond to the commitment. The ITS plan also restricted its participants from displaying quotes that locked or crossed the quote of another participant.

(2) As a result, no ITS participant could trade at a faster pace than the slowest ITS participant market, if this trading would result in trade-throughs or locking the quotes of the slower market.

2. Adoption of Regulation NMS. In response to these concerns and to catalyze change in exchange floor-based trading without risking inferior executions for

customer orders, the SEC in June 2005 adopted Regulation NMS, which added several new rules and amended others. *See* the Regulation NMS Adopting Release. Regulation NMS introduced three new rules: (1) the Order Protection Rule (Rule 611); (2) the Access Rule (Rule 610); and (3) the Sub-Penny Rule (Rule 612); and amended the Market Data Rules (Rules 600, 601 and 603).

(a) **Order Protection Rule**. Rule 611(a)(1) requires a trading center to establish, maintain and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of "protected quotations" in NMS stocks that do not fall within any of the exceptions described below.

(1) The purpose of this rule is to eliminate all trade-throughs that reasonably can be prevented, while also recognizing the inherent difficulties of eliminating trade-through transactions that, despite a trading center's reasonable efforts, may occur.

(2) The order protection rule updated and replaced the ITS trade-through rule and extended to all trading in NASDAQ and exchange-listed equities.

(3) The order protection rule requires policies and procedures and was not intended to make each trade-through a violation of the rule. Examinations by the SEC and SROs have focused on the adequacy of procedures.

(b) Exceptions to Order Protection Rule:

(1) **Rule 611(b)(1)**: excepts transactions if the trading center that was traded through was experiencing a failure, material delay or malfunction of its systems or equipment when the trade-through occurred. This exception is sometimes referred to as the "self-help" exception.

(2) **Rule 611(b)(2)**: excepts transactions other than "regular way" contracts.

(3) **Rule 611(b)(3)**: excepts single-price opening, reopening or closing transactions.

(4) **Rule 611(b)(4)**: excepts transactions executed at a time when protected quotations were crossed.

(5) **Rule 611(b)(5)**: allows a trading center immediately to execute any order identified as an intermarket sweep order.

(6) **Rule 611(b)(6)**: allows a trading center to route intermarket sweep orders and thereby clear the way for immediate

executions at the intermarket sweep orders' price, which enables traders to control the execution of their orders.

(7) **Rule 611(b)(7)**: excepts the execution of an order at a benchmark price that is not based, directly or indirectly, on the quoted price of an NMS stock at the time of execution and for which the material terms are not reasonably determinable at the time the commitment to execute the order is made (*e.g.*, a VWAP order).

(8) **Rule 611(b)(8)**: excepts transactions based on "flickering quotations," where the order that trades through matches a price displayed by the trading center within one second prior to execution of the trade-through.

(9) **Rule 611(b)(9)**: excepts certain "underwater" stopped orders, where the price of the execution of the order is, for a stopped buy order, lower than the national best bid at the time of execution or, for a stopped sell order, higher than the national best offer at the time of execution.

(c) **IEX Application**. In August 2015, the Investors' Exchange LLC ("**IEX**") filed an application with the SEC to register as a national securities exchange, which the SEC has not yet approved. IEX, which was the subject of Michael Lewis's *Flash Boys* book, currently operates as an ATS and has implemented an intentional "speed bump" delay to all orders entering its systems, in an effort to partially address what IEX perceives to be unfair advantages enjoyed by firms that employ high-frequency trading strategies and technologies. However, some commenters on IEX's exchange application have raised questions and concerns regarding whether, due to the intentional delay, IEX's displayed quotations would fail to meet the definition of an "automated quotation" in Regulation NMS and therefore not be "protected quotations" eligible for the Order Protection Rule.

(d) **Access Rule**. The SEC has stated that for the national market system to fulfill its statutory objectives, fair and efficient access to each of the individual markets that participate in the national market system is essential. This principle is a recurring issue as markets innovate and develop; in particular, it has been raised in the discussions concerning high frequency trading and dark pools.

(1) **Rule 610(a)**: prohibits an SRO from imposing unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access through a member of the SRO to the quotations in an NMS stock displayed by the SRO trading facility.

(2) **Rule 610(b)(1)**: requires any trading center that displays quotations in NMS stocks through an SRO display-only facility to provide a level and cost of access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities.

(3) **Rule 610(c)**: caps the fees that can be charged for access to protected quotations and manual quotations at the best bid and offer at three-tenths of a cent per share, a purely pragmatic amount that reflected market practice at the time. It also allows market makers, in addition to alternative trading systems, to charge these fees. For a critique of these fees, *see* James J. Angel, Lawrence E. Harris and Chester S. Spatt, *Equity Trading in the 21st Century* (Feb. 23, 2010), *available at* http://ssrn.com/abstract=1584026. *See also* discussion in Section II.D.3(g) below.

(i) The fees are not reflected in the displayed quote.

(ii) The rule generally does not include fees not triggered by the execution of orders against protected quotations, such as periodic fees.

(4) **Rule 610(d)**: requires that each national securities exchange and national securities association establish, maintain and enforce written rules to preclude display of quotations that lock or cross any protected quotation in an NMS stock.

3. Sub-Penny Rule.

(a) Rule 612 provides that no market participant "shall display, rank, or accept from any person a bid or offer, an order, or an indication of interest in any NMS stock priced in an increment smaller than $0.01 if that bid or offer, order or indication of interest is priced equal to or greater than $1.00 per share."

(b) Rule 612 does not prohibit a sub-penny execution resulting from a midpoint or VWAP algorithm or from price improvement, so long as the execution did not result from an impermissible sub-penny order, ranking or quotation.

(c) The SEC has exempted some exchanges from the Sub-Penny Rule of Rule 612 in connection with retail liquidity programs, as discussed in further detail below. *See* Section II.D.3(f).

4. Market Data Revenues. The SEC adopted amendments to the joint industry plans for consolidated quote and transaction reporting. Under the plans, SROs operate market information networks, which collect market data from the networks'

individual SRO participants and distribute such market data to broker-dealers and data vendors for a fee. The SEC adopted amendments to the plans with a goal of incorporating a broad-based measure of the contribution of an SRO's quotes and trades to the consolidated data stream. The formula uses the following two steps:

(a) First, a network's distributable revenue is allocated among the many individual securities included in the network's data stream.

(b) Second, the revenues that are allocated to an individual security are allocated among the SROs based on measures of the usefulness to investors of the SROs' trades and quotes in the security.

5. Market Data Rules. Regulation NMS also includes rules regarding the dissemination of quotation and transaction data, and the distribution, consolidation and display of information regarding quotations for and transactions in NMS stocks.

(a) Rule 601 requires members of an SRO to transmit their trades to the SRO, but also allows such members to distribute their own data independently, with or without fees.

(b) Rule 603(a)(1) requires that any market information distributed by an exclusive processor, or by a broker-dealer that is the exclusive source of the information, be made available to vendors on terms that are fair and reasonable.

(c) Rule 603(a)(2) requires that any SRO or broker-dealer that distributes market information must do so on terms that are not unreasonably discriminatory.

(1) In September 2012, the SEC issued an order against the NYSE and its parent company, NYSE Euronext, finding that the exchange violated Rule 603(a) over an extended period of time by sending data through two of its proprietary feeds before sending data to the consolidated feeds. The SEC also found that the exchange violated the record retention provisions of Exchange Act Section 17(a)(1) and Rule 17a-1 by failing to retain computer files that contained information about its transmission of market data. *See* SEC Press Release 2012-189 (Sept. 14, 2012); Exchange Act Release No. 67857 (Sept. 14, 2012).

(d) Rule 603(b) requires SROs to continue to participate in joint SRO plans to consolidate and jointly disseminate quotation and transaction information for NMS stocks, but allows an SRO to distribute its data independently, with or without fees.

(e) Rule 603(c) requires data vendors and broker-dealers to provide consolidated information on quotations and trades in an equivalent manner to any other information on quotations and trades provided by the data vendor or

broker-dealer when used in a context in which a trading or order-routing decision could be implemented. Rule 603(c) does not apply to market data provided on a purely informational website that does not offer any trading or order-routing capability. If a broker-dealer or its registered representative provides a quotation to a customer that can be used to assess the current market or the quality of trade execution, reliance on a market data feed that contains only a subset of consolidated market data as the source of that quotation would not be consistent with Rule 603(c). *See* FINRA Regulatory Notice 15-52; BATS Global Markets, Inc., SEC Denial of No-Action Letter (July 22, 2015).

6. Implementation of Regulation NMS.

(a) Regulation NMS fundamentally changed the way that the market operates. Implementation of Regulation NMS entailed a cooperative effort by the regulators and the industry to resolve open issues and implement appropriate systemic changes. The trading systems at every firm and exchange had to be changed to accommodate the new trading rules. The SEC issued a series of FAQs resolving many repeat questions. *See* Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS, http://www.sec.gov/divisions/marketreg/nmsfaq610-11.htm; Responses to Frequently Asked Questions Concerning Rule 612 of Regulation NMS, http://www.sec.gov/divisions/marketreg/subpenny612faq.htm.

(b) After a massive two-year effort, the NMS trading rules were effectively implemented in August 2007 without major market disruption. While the rules have generally worked effectively to regulate trading in the equity markets, as discussed below, the SEC is in the process of reviewing market developments in the wake of Regulation NMS and the further automation of trading in the equities markets. *See* Section II.

C. Short Sale Rules.

1. Emergency Rules. During the 2008 financial crisis, the SEC imposed a series of emergency orders to rein in short selling in stocks of financial companies. *See*, *e.g.*, Exchange Act Release No. 58166 (July 15, 2008) (order requiring pre-borrows for certain listed securities). The SEC also adopted on an emergency basis temporary Rule 204T, designed to reduce fails to deliver of equity securities, particularly those arising from short sales, and temporary Rule 10a-3T, designed to provide the SEC with information regarding the short positions of all major market participants. *See* Exchange Act Release Nos. 58773 (Oct. 14, 2008) (adopting temporary Rule 204T) and 58785 (Oct. 15, 2008) (adopting temporary Rule 10a-3T).

2. Delivery Obligations. On July 27, 2009, the SEC adopted Rule 204, making permanent the firm delivery and close-out requirements of temporary Rule 204T. *See* Exchange Act Release No. 60388 (July 27, 2009).

(a) **Accelerated Close-Outs**. Rule 204(a) provides that participants of registered clearing agencies must deliver equity securities to the clearing agency by the settlement date, or if a participant has a fail to deliver position at the clearing agency relating to a short sale, the participant must immediately close out the position by either borrowing or purchasing the shares before the beginning of trading hours on the first settlement day after the settlement date or suffer a penalty. Fails relating to long sales or bona fide market-making activity have two additional settlement days before they must be closed out.

(b) **Pre-Borrow Penalty**. Rule 204(b) provides that if a participant fails to close out an open fail by the deadline, the participant and any broker-dealer from which it receives trades for clearance and settlement become subject to a penalty (the "**Pre-Borrow Penalty**") requiring them to first borrow or arrange to borrow the security before accepting any short sales orders or effecting short sales for its own account in the security. The Pre-Borrow Penalty remains in effect until the open fail is closed out by purchasing (not borrowing) the securities.

(c) **Pre-Fail Credit**. Rule 204(e) provides that a broker-dealer can avoid the close-out requirement or Pre-Borrow Penalty by purchasing or borrowing enough shares to offset its fail, subject to certain conditions, including the amount and timing of the purchase.

(d) **Sham Close-Outs**. Rule 204(f) specifies that the purchase or borrow of securities will not qualify as a close-out if the participant knows or has reason to know the securities will not actually be delivered in settlement.

(1) Shortly after adoption of Rule 204, the SEC announced enforcement actions involving alleged sham close-outs. Two August 2009 settlements involved options traders and their broker-dealers that "improperly claimed that they were entitled to an exception to the locate requirement, and engaged in transactions that created the appearance that they were complying with the close-out requirement." *See* SEC Press Release 2009-179 (Aug. 5, 2009).

(2) In January 2012, the Chicago Board of Options Exchange ("**CBOE**") issued a circular to remind participants of the requirement to immediately close out fail to deliver positions by borrowing or purchasing securities of like kind and quantity by no later than the applicable deadline. *See* CBOE Regulatory Circular RG12-022 (Jan. 30, 2012).

(3) In January 2012, the SEC charged two options traders for failing to locate shares involved in short sales and failing to close out the resulting failures to deliver. *See* SEC Press Releases 2012-22 (Jan. 31, 2012) and 2012-137 (July 17, 2012).

(4) In April 2012, the SEC charged an online brokerage and clearing agency and officials of the firm and a customer for engaging in a series of sham "reset" transactions designed to give the illusion that the firm had purchased securities of like kind and quantity. *See* SEC Press Release 2012-66 (Apr. 16, 2012).

(e) **Recordkeeping and Compliance**. The Rule 204 adopting release also reiterated the importance of good recordkeeping and compliance procedures, and noted the SEC's intent to examine firms for compliance. In addition, because Rule 204 applies to all equity securities, it effectively supplants (but does not actually remove) the close-out requirements for "threshold" securities under Rule 203(b)(3) of Regulation SHO.

(f) **Trading Impact**. While Rule 204 does not directly control the price or manner of trading, its delivery requirements effectively limit the scale and duration of naked short selling, because of the need to cover the short sales by T+4 to avoid the pre-borrow requirement.

3. Short Sale Rules—Affirmative Determination Requirement. Under Rule 203 of Regulation SHO, a broker-dealer may not accept a short sale order from another person or effect a short sale for its own account unless it has either: (1) borrowed the security, or entered into a bona fide arrangement to borrow the security, or (2) reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due.

(a) In October 2011, FINRA fined UBS Securities for violating Regulation SHO after FINRA found that UBS placed millions of short sale orders without locates and mismarked millions of sale orders in its trading systems. *See* FINRA Press Release, *FINRA Fines UBS Securities $12 Million for Regulation SHO Violations and Supervisory Failures* (Oct. 25, 2011); FINRA Letter of Acceptance, Waiver and Consent No. 2008014451101 (Oct. 24, 2011).

(b) In December 2011, FINRA fined Credit Suisse Securities for violating Regulation SHO after FINRA found that Credit Suisse placed millions of short sale orders without locates and mismarked millions of sale orders in its trading systems. *See* FINRA Press Release, *FINRA Fines Credit Suisse Securities $1.75 Million for Regulation SHO Violations and Supervisory Failure*s (Dec. 27, 2011); FINRA Letter of Acceptance, Waiver and Consent No. 20080144512 (Oct. 14, 2011).

(c) In January 2016, the SEC fined Goldman, Sachs & Co. for violating Regulation SHO. The SEC found that when Goldman Sachs' automated inventory model for granting locate requests was depleted, it continued to grant locate requests without checking alternative sources of securities or performing a meaningful further review. *See* Exchange Act Release No. 76899 (Jan. 14, 2016).

4. Short Sale Rules—Price Test Rules. In response to claims that the SEC's elimination in 2007 of the historic uptick short sale restriction, Rule 10a-1, unleashed waves of short selling abuse in the markets, and the political pressure placed on the SEC, on February 24, 2010, the SEC adopted a revised price test, Rule 201 of Regulation SHO, which became effective on March 10, 2010.

(a) Rule 201 of Regulation SHO institutes what the marketplace has termed a "circuit breaker with a passive upbid requirement" rather than a full-time restriction on short sales.

(1) The restriction goes into effect upon a 10% decline in the price of an NMS stock from its previous day's closing price.

(2) Rule 201 effectively restricts the display or execution by exchanges and other trading centers of a short sale order in such stock to a price above the national best bid for the remainder of the trading day and the next trading day.

(3) Rule 201 is implemented through policies and procedures of trading centers and broker-dealers that are not, themselves, trading centers.

(4) There are limited exceptions from the basic requirement, including for arbitrage and odd lot transactions. There is no exception for market making in NMS stocks or options market making.

(5) In its adopting release, the SEC states that Rule 201 strikes a balance between the goal of preventing short selling from being used to exacerbate a declining market in a security and the need to allow for the smooth functioning of the markets, including the provision of liquidity and price efficiency.

(b) In connection with Rule 201, the SEC also amended Rule 200 of Regulation SHO to require all brokers and dealers to mark all orders for sale of an equity security as "long," "short" or "short exempt."

(1) Short sale orders may only be marked "short exempt" under two scenarios. First, an order can be marked "short exempt" under Rule 201(c) if it is at a price above the current national best bid at the time of submission. Second, orders may be marked "short exempt" pursuant to one of the exceptions from Rule 201. In order to mark orders as "short exempt," a broker-dealer must have written policies and procedures that are reasonably designed to prevent inaccurate marking and must regularly monitor for and remedy any problems with the policies and procedures.

(2) Narrow exceptions to Rule 201 are effected through provisions allowing a broker-dealer to mark "short exempt" those orders that it reasonably believes fall into certain defined categories. These include seller's delay in delivery, odd lot transactions by market makers, overallotments and layoffs, riskless principal transactions to facilitate customer transactions, VWAP transactions and domestic and international arbitrage transactions.

(3) There are no exceptions from Rule 201 for bona fide hedging, bona fide market making (including market making in OTC and listed derivatives, options, convertible securities or exchange-traded funds), benchmark trades otherwise exempted from Regulation NMS, sales effected in connection with capital raising transactions, "exchange for physicals," exchange-traded fund transactions or market on close or market on open transactions.

5. Short Sale Rules—FAQs. The staff of the Division of Trading and Markets has posted Regulation SHO FAQs on its website. The FAQs provide guidance that is relevant to the compliance practices of broker-dealers and high frequency trading firms, including guidance on marking orders. *See* Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, *available at* http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

II. Current Issues in the Equity Markets. Technological innovations have driven rapid changes in the equity markets over the last several years. The continued advances in electronic markets dominated by the use of computer algorithms to generate, cancel, route and match orders has significantly increased efficiency and reduced costs, but also led to increased complexity and the potential for errors with widespread negative consequences. High-profile events, such as the May 6, 2010 "2010 Flash Crash," and technology failures, such as the NASDAQ system errors that occurred during the May 18, 2012 IPO of Facebook, along with popular media allegations of a "rigged market" have focused the public, Congress and the SEC's attention on equity market structure. During testimony in early 2014, SEC Chair Mary Jo White announced that the SEC was in the process of a "comprehensive review of market structure issues, including high-frequency and off-exchange trading practices" by taking "a data-driven, disciplined approach." *See* SEC Chair Mary Jo White, Testimony before the U.S. House Subcommittee on Financial Services and General Government (Apr. 1, 2014) and Testimony on "Oversight of the SEC's Agenda, Operations and FY 2015 Budget Request" before the U.S. House Committee on Financial Services (Apr. 29, 2014). In June 2014, SEC Chair White outlined her plan for several regulatory reforms of the equity markets. *See* SEC Chair Mary Jo White, *Enhancing Our Equity Market Structure* (Remarks to Sandler O'Neill & Partners, L.P. Global Exchange and Brokerage Conference, June 5, 2014) ("**White June 5, 2014 Speech**"). *See also* Section II.D.2(c) below. SEC Commissioners Daniel Gallagher and Michael Piwowar also called for a "holistic" and comprehensive review of the equity market structure. *See, e.g.*, SEC Commissioner Daniel M. Gallagher, *Market 2012: Time for a Fresh Look at Equity Market Structure and Self-Regulation* (Remarks to SIFMA's 15th Annual Market Structure Conference, Oct. 4, 2012); SEC

Commissioner Michael S. Piwowar, *The Benefit of Hindsight and the Promise of Foresight: A Proposal For A Comprehensive Review of Equity Market Structure* (Remarks to ICI Global Trading and Market Structure Conference, Dec. 9, 2013).

On January 20, 2015, the SEC implemented one of Chair White's proposals and established a new Equity Market Structure Advisory Committee. This advisory committee has focused on issues relating to the structure and operations of the U.S. equities market and functions as a formal mechanism for the SEC to receive advice and recommendations relating to these issues. *See* Exchange Act Release No. 74092 (Jan. 20, 2015). Additionally, as discussed in Section II.B.2(e) below, FINRA has also renewed its focus on market structure issues, announcing a series of regulatory initiatives in September 2014. *See* Update: FINRA Board of Governors Meeting (Sept. 19, 2014), *available at* https://www.finra.org/industry/update-finra-board-governors-meeting-91914.

A. 2010 Flash Crash and Response.

1. 2010 Flash Crash. The 2010 Flash Crash occurred on the afternoon of May 6, 2010 when the Dow Jones plunged 1,000 points before recovering in approximately 20 minutes. Due to the magnitude and speed of both the drop and recovery in security prices, the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues investigated the market events of May 6, 2010 and on February 18, 2011 published its report on its findings, including recommendations. Many of these recommendations formed the regulatory response to the 2010 Flash Crash.

2. Regulatory Responses.

(a) **The Market Access Rule**. On November 3, 2010, the SEC adopted Rule 15c3-5, which requires broker-dealers providing access to trading directly on an exchange or ATS, including those providing sponsored or direct market access to customers or other persons and ATSs providing access to the ATS to non-broker-dealers, to implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks of this business activity. The required controls and procedures effectively prohibit the practice of unfiltered or naked access to an exchange or ATS, whereby a broker-dealer whose trading identifier is used by a high frequency trader to access the market does not apply any pre-trade risk management systems to review the orders being transmitted to the markets. *See* Exchange Act Release No. 63241 (Nov. 3, 2010). Although proposed before the 2010 Flash Crash, in ultimately adopting the rule, the SEC cited the 2010 Flash Crash as one of the events demonstrating the need for the rule.

(1) **Rule 15c3-5 Requirements**.

(i) The rule requires the financial and regulatory risk management controls and supervisory procedures to be under the

direct and exclusive control of the broker-dealer with market access.

(ii) Under the rule, a broker-dealer providing market access may reasonably allocate, by written contract, control over specific regulatory risk management controls and supervisory procedures to a customer that is a registered broker-dealer. To do so, the broker-dealer providing market access must have a reasonable basis for determining that such broker-dealer customer has better access to the ultimate customer and its trading information such that it can more effectively implement the specified controls and procedures. However, even if responsibilities are allocated between broker-dealers, the broker-dealer providing access has ultimate responsibility for the obligations under the rule.

(iii) The rule requires broker-dealers that are subject to the rule to establish, document and maintain a system for regularly reviewing their risk management controls and supervisory procedures. Broker-dealers must include an annual review to assure the effectiveness of the controls and procedures, which must be conducted in accordance with written procedures that are reasonably designed to assure that the broker-dealer's controls and procedures are adjusted as necessary.

(2) **Enforcement Actions**. The SEC and FINRA have brought several enforcement actions against broker-dealers for alleged violations of Rule 15c3-5.

(i) In its first enforcement action relating to Rule 15c3-5, the SEC instituted proceedings against Knight Capital in connection with the trading errors that caused Knight to lose $460 million. The SEC alleged, among other things, that Knight failed to have reasonably designed controls to prevent the entry of erroneous orders at a point immediately prior to the submission of orders to the market, and failed to have reasonably designed controls to prevent the entry of orders that exceeded pre-set capital thresholds. *See* Exchange Act Release No. 70694 (Oct. 16, 2013).

(ii) In June 2014, FINRA settled charges with Citadel Securities LLC for failure to prevent the transmission of erroneous orders to other exchanges during a three-year period. FINRA alleged that Citadel failed to establish, maintain and enforce a supervisory system, including supervisory procedures and risk management controls reasonably designed to check for

order accuracy, reject orders that exceeded the appropriate price or size parameters, reject duplicative orders and monitor appropriate message level activity. *See* FINRA Letter of Acceptance, Waiver and Consent No. 2010022334505 (June 16, 2014).

(iii) On November 20, 2014, Wedbush Securities settled a pending SEC enforcement action in connection with alleged market access violations. The SEC alleged, among other things, that Wedbush violated the market access rule by failing to have adequate risk controls in place before providing customers with access to the market, including some customer firms with thousands of overseas traders. Specifically, Wedbush allegedly did not directly set or monitor regulatory risk settings in the third-party or client-proprietary trading platforms used by the majority of its customers as required by paragraph (d) of Rule 15c3-5 because, while Wedbush provided a gateway for its customers' trading firms to the U.S. markets, the majority of the trading activity did not flow through a Wedbush system before reaching exchanges and other trading venues in the United States. The SEC further alleged that Wedbush's lack of reasonably designed market access controls resulted in violations of other regulatory requirements, such as Regulation NMS and Regulation SHO. *See* Exchange Act Release No. 73652 (Nov. 20, 2014).

(iv) On December 10, 2014, the SEC took enforcement action against Morgan Stanley & Co. LLC for violating Rule 15c3-5 when it allegedly failed to enforce credit limits for a customer firm with a rogue trader who engaged in fraudulent trading. The SEC alleged that Morgan Stanley's electronic trading desk did not conduct adequate due diligence prior to manually increasing the customer's credit limits to ensure that the credit limit increases were warranted and its written supervisory procedures did not provide reasonable guidance for electronic trading desk personnel who determine whether to increase customer trading thresholds. *See* Exchange Act Release No. 73801 (Dec. 10, 2014).

(v) On June 30, 2015, the SEC took enforcement action against Goldman, Sachs & Co. for violating Rule 15c3-5 when the firm erroneously sent approximately 16,000 mispriced options orders to various options exchanges in less than an hour on August 20, 2013. The SEC found that these trades resulted from a series of failures in the firm's system of risk management

controls and supervisory procedures. The SEC also found that the firm had deficiencies in its risk management controls and supervisory procedures designed to prevent orders that exceed the firm's pre-set capital threshold. *See* Exchange Act Release No. 75331 (June 30, 2015).

(vi) On September 30, 2015, the SEC sanctioned Latour Trading LLC for allegedly violating Rule 15c3-5 and Regulation NMS over a four-year period. According to the SEC, due to a coding error made by the firm's parent company, the firm sent millions of orders that did not comply with Regulation NMS to various exchanges. In addition, the SEC found that the firm lacked direct and exclusive control over its financial and regulatory risk management controls, which is required by Rule 15c3-5. *See* Exchange Act Release No. 76029 (Sept. 30, 2015).

(b) **Clearly Erroneous Trades**. On May 6, 2010, the day of the 2010 Flash Crash, the exchanges broke trades in a manner that was criticized by many as being arbitrary and lacking transparency. In response to the events of May 6, the exchanges and FINRA modified their rules for nullifying "clearly erroneous" trades in order to "clarify the clearly erroneous execution review process across all markets, and reduce the discretion of the Exchanges to deviate from the objective standards in their respective rules relating to clearly erroneous transactions." *See* Exchange Act Release Nos. 62885 (Sept. 10, 2010) and 62886 (Sept. 10, 2010). The amended rules specify objective thresholds and standards for breaking trades. Among other things, the amended rules specify that a trade will be considered "clearly erroneous" if the price of the transaction to buy (sell) that is the subject of a complaint is greater (less) than a reference price by an amount that equals or exceeds certain specified numerical guidelines. As approved, the rules were to be in effect on a pilot basis through December 10, 2010. The effective date of the pilot program has subsequently been extended several times, with the SROs most recently amending their rules to provide that the pilot program's duration will coincide with the Limit Up-Limit Down Plan. *See* Section II.A.2(e)(2) below.

(1) The amended rules for canceling clearly erroneous trades apparently restricted NYSE's ability to cancel inadvertent trades that Knight submitted on August 1, 2012 as a result of a software problem, which ultimately resulted in a $440 million loss to Knight. *See generally* Nina Mehta, *Knight $440 Million Loss Sealed by New Rules on Canceling Trades*, Bloomberg (Aug. 14, 2012).

(c) **Enhanced Quotation Requirements for Market Makers**. On November 5, 2010, the SEC approved rule changes for FINRA and most of the exchanges regarding enhanced quotation requirements for market makers. The

proposed rules would require market makers to maintain two-sided quotes within a certain percentage of the NBBO. The rule effectively prohibits "stub quotes." For securities subject to the individual stock circuit breaker pilot plan, quotes must be no more than two percentage points away from the circuit breaker trigger, *i.e.*, 8%. Once a compliant quote is entered, it may rest without adjustment until such time as it moves within 1/2 of 1% of the applicable circuit breaker, *i.e.*, 9.5%, at which point the market maker must immediately move its quote back to at least the permissible 8% level. During times in which a circuit breaker is not applicable (*i.e.*, before 9:45 a.m. and after 3:35 p.m.), a trigger percentage of 22% will be assumed. Thus, a market maker must maintain a quote no further than 20% away from the NBBO and the quote may rest without adjustment until it is more than 21.5% from the NBBO. For securities not subject to any individual stock circuit breaker, there is an assumed hypothetical 32% circuit breaker. If there is no NBBO, the last reported sale price is used as the applicable reference price. *See* Exchange Act Release No. 63255 (Nov. 5, 2010).

(d) **Large Trader Reporting System**. To increase its ability to monitor high frequency and institutional trading, in July 2011 the SEC adopted Exchange Act Rule 13h-1, establishing a large trader reporting system. The rule requires "large traders" in NMS stocks and options (any persons who trade two million shares or shares with a fair market value of $20 million in a single day, or twenty million shares or shares with a fair market value of $200 million in a single month, or listed option equivalents) to register with the SEC and obtain a unique large trader identification number, which they must provide to their registered broker-dealers. The SEC will use the large trader identification number to collect information about the orders and transactions of large traders across registered broker-dealers, analyze their activity and monitor the impact of their trades on the markets. This information will also be used for enforcement purposes and to reconstruct trading activity following periods of unusual market volatility.

(1) Under the rule, registered broker-dealers must keep records of large traders' transactions, be able to report this information to the SEC by the morning after the transactions were effective (unless in unusual circumstances where the SEC requests a same-day submission) and monitor for compliance by putative large traders with the registration requirements.

(2) The rule imposes a burden on persons that engage in significant trading in NMS stocks and options to develop and maintain centralized information concerning affiliate and broker-dealer relationships. The registration requirements present particular challenges for financial conglomerates that did not previously obtain or manage this information centrally and for companies that do not exert sufficient practical control over affiliates to permit adequate compliance oversight.

Because the trigger level for registration is relatively low and has few exceptions, many entities may cross the threshold level unexpectedly (such as by acquiring a block of NMS stocks with a value of $20 million in a single corporate transaction) and then be subject to registration and updating requirements for at least a year.

(3) The broad jurisdictional reach of the registration requirements means that many non-U.S. investors and investment managers become subject to the registration requirements merely because their trades are effected through their accounts at U.S. broker-dealers. Because registered broker-dealers are permitted to effect trades for unidentified large traders, there is a risk of noncompliance, particularly among traders who use non-registered broker-dealer intermediaries to effect their transactions.

(4) Large traders were required to comply on December 1, 2011, and registered broker-dealers were originally required to comply by April 30, 2012, although after a series of exemptive orders, registered broker-dealers were required to comply with the bulk of the recordkeeping and reporting requirements by November 1, 2013, with certain remaining obligations requiring compliance by November 1, 2017. *See* Exchange Act Release No. 66839 (Apr. 20, 2012), Exchange Act Release No. 70150 (Aug. 8, 2013), Exchange Act Release No. 76322 (Oct. 30, 2015).

(5) The SEC has permanently exempted certain capital market transactions from the definition of "transaction," these include (1) transactions that are part of an offering of securities by or on behalf of an issuer, or an agent for an issuer, whether or not such offering is subject to registration under the Securities Act of 1933, regardless of whether such transaction is effected through the facilities of a national securities exchange, and (2) sales of securities by a selling shareholder in connection with an initial public offering or in a registered secondary offering if such selling shareholder is a current or former employee of the issuer and the securities being sold were acquired as part of the person's compensation as an employee of the issuer. This reflects an expansion, by exemptive order, of the exemptions already contained in the rule itself. *See* Exchange Act Release No. 66839 (Apr. 20, 2012).

(6) On October 30, 2015, the SEC issued an exemptive order that provides an alternative method of calculating whether equity options trading activity triggers the large trader threshold, allowing the calculation in certain circumstances to be based on option premium paid, rather than value of the equity securities underlying the options. *See* Exchange Act Release No. 76322 (Oct. 30, 2015).

(e) **Volatility**.

(1) **Single-Stock Circuit Breaker Pilot Plan**. One initial response to the 2010 Flash Crash was the development of the single-stock circuit breaker pilot plan, which was implemented through a series of rule filings by the national securities exchanges and FINRA. Under the single-stock circuit breaker pilot plan, a trading pause was triggered for an individual security if the price of the security moved by 10% as compared to the price of that security in the preceding five-minute period during the trading day. This pilot plan was introduced in three stages, beginning in June 2010. In the first stage, the SEC approved proposed rule changes by the national security exchanges and FINRA to pause trading during periods of extraordinary market volatility in stocks included in Standard & Poor's 500 Index. In the second stage, the SEC approved the national security exchanges' and FINRA's proposals to add securities included in the Russell 1000 index, as well as specified exchange-traded products, to the pilot plan. In the third stage, the SEC approved the national security exchanges' and FINRA's proposals to add all remaining NMS stocks to the pilot plan. The national security exchanges and FINRA each subsequently filed proposals to exempt all rights and warrants from the pilot plan. The single-stock circuit breaker pilot plan expired on April 8, 2013, at which time it was replaced by the Limit Up-Limit Down Pilot Plan, discussed below. *See generally* Exchange Act Release No. 66134 (Jan. 11, 2012) and 67556 (Aug. 1, 2012).

(2) **Limit Up-Limit Down Pilot Plan**. On May 31, 2012, the SEC approved proposals submitted by the national securities exchanges and FINRA to establish a "limit up-limit down" pilot plan, which replaced the single-stock circuit breaker pilot plan. The pilot plan requires exchanges, ATSs, broker-dealers and other trading centers to establish policies and procedures that prevent the execution of trades and the display of offers outside of a specified price band. Price bands for each security will generally be set (and reset throughout the trading day) at a percentage above and below the security's average price over the prior five minutes of trading. The price band for most stocks in the S&P 500 Index and the Russell 1000 Index, as well as certain exchange-traded funds and notes that have been designated in the SEC's release, is 5%. The price band for most other listed stocks and certain other exchange-traded instruments is 10%. Price bands are doubled during opening and closing periods, and broader price bands apply at all times for listed stocks and exchange-traded instruments priced at or below $3.00. If bid or offer quotations are at the far limit of the price band for more than 15 seconds, trading in that security will be subject to a five-minute trading pause. The limit up-limit down pilot plan became effective on a one-

year pilot basis on April 8, 2013 and has since been extended through April 22, 2016. On February 22, 2016, the SEC solicited comments on a proposal to extend the pilot plan to April 21, 2017. *See* Exchange Act Release No. 67091 (May 31, 2012), Exchange Act Release No. 76244 (Oct. 22, 2015), Exchange Act Release No. 77205 (Feb. 22, 2016).

(3) **Updated Market-Wide Circuit Breakers**. On May 31, 2012, the SEC approved a proposal by the national securities exchanges and FINRA to update the market-wide circuit breakers. The program, which went into effect on April 8, 2013, provides for specified market-wide trading halts following certain "Level 1," "Level 2" and "Level 3" market declines. Levels 1, 2 and 3 are calculated daily, using 7%, 13% and 20%, respectively, of the S&P 500 Index, compared to the prior day's closing value. The length of halts for each Level depend on the time of day the halt is triggered. A Level 1 or Level 2 decline that occurs after 9:30 a.m. and at or before 3:25 p.m. will trigger a halt lasting for fifteen minutes. No halt is triggered if a Level 1 or Level 2 decline occurs after 3:25 p.m., and Level 1 or Level 2 declines will only trigger a halt once per day. If a Level 3 decline occurs at any time during the day, trading is halted until the next trading day. *See* Exchange Act Release No. 67090 (May 31, 2012). The pilot is scheduled to continue for so long as the limit up-limit down pilot plan is in effect.

(i) The current pilot market-wide circuit breakers revise the market-wide circuit breaker program put into place in October 1988 in a number of ways. The prior program referenced a decline in the Dow Jones Industrial Average, rather than the S&P 500, and was based on 10%, 20% and 30% declines compared to the average closing price during the prior quarter, rather than the prior day's S&P 500 value. The prior circuit breaker program also referred to six different time periods, rather than one, which would trigger trading halts of durations longer than the current program (30, 60 or 120 minutes, rather than 15).

(f) **Consolidated Audit Trail**. Trading activity in NMS stocks is currently tracked through a number of uncoordinated systems, including FINRA's Order Audit Trail System, the NYSE's Order Tracking System and the multi-SRO Consolidated Options Audit Trail System. No single system tracks orders routed through multiple SROs or all activity in a particular NMS stock across all SROs. On July 11, 2012, the SEC adopted Rule 613 of Regulation NMS, which requires the SROs to jointly file a national market system plan (the "**CAT Plan**") that will govern the creation, implementation and maintenance of a consolidated audit trail (the "**CAT**") for the listed equities and options markets. Rule 613 sets in motion a vast, multi-year project that will culminate in the

creation of a comprehensive, real-time data repository for all information concerning orders and executions. This repository will permit the SEC and the SROs to query and analyze in real time all trading activity in covered securities. *See* Exchange Act Release No. 67457 (July 11, 2012).

(1) The CAT will ultimately revolutionize securities surveillance and enforcement by eliminating many of the delays and much of the imprecision resulting from the disparate, unlinked and in many cases manual processes that currently exist.

(2) However, Rule 613 places on the SROs a very significant cost and burden of developing and operating the industry utility that would be the core of the CAT, retooling current surveillance methodologies and enforcing compliance by member broker-dealers. Broker-dealers will also have to shoulder considerable costs of compliance, and may be charged substantial fees to fund the SROs' cost in building and maintaining the CAT.

(3) The CAT Plan is required to include policies and procedures to ensure the confidentiality of information reported to the CAT, including, for example, a mechanism to track persons accessing CAT data and information barriers between exchange and FINRA regulatory staff and non-regulatory staff with respect to CAT data. While the SEC also said that it "intends to assert all appropriate exemptions" in response to any requests for CAT data under the Freedom of Information Act, questions still remain whether, in response to a subpoena issued in a civil litigation, data can be effectively protected from further use or disclosure.

(4) Rule 613 requires that the CAT initially cover secondary market transactions in U.S. listed stocks and options and contemplates that CAT will be expanded to a wider range of other securities over time. As suggested by market participants, the proposed CAT Plan includes OTC equities.

(5) The SEC noted in the adopting release that once CAT is fully adopted, certain other broker-dealer reporting obligations may become unnecessary. This may include the need for broker-dealers to track large traders and unidentified large traders under Rule 13h-1, as the SEC will be able to use the CAT to identify and monitor these large traders. *See* Section II.A.2(d) above.

(6) On February 26, 2013, the SROs published a request for proposals to obtain detailed information from bidders regarding their abilities and expected cost to build, operate, administer and maintain the CAT.

(i) In order to establish a process for selecting a bidder, the SROs filed, and the SEC approved, an NMS plan setting forth how the SROs will formulate and submit the CAT plan, including how they will review and evaluate bids and select the plan processor, including managing potential conflicts of interest that arise where bids are received from SROs. *See* Exchange Act Release No. 71596 (Feb. 21, 2014).

(ii) As a result of this process, on April 24, 2014, the SROs announced that they had deemed ten bids to be "qualified bids," including one from an SRO (FINRA). *See* Qualified CAT Bid List (Apr. 24, 2014) *available at* http://catnmsplan.com/process.

(7) On September 30, 2014, the SROs submitted a proposed CAT Plan to the SEC. On February 27, 2015, the SROs submitted a revised CAT Plan to replace the one previously submitted. The revised CAT Plan would establish a Delaware limited liability company ("**CAT NMS, LLC**") to house the activities related to the CAT. Each exchange and national securities association currently registered with the SEC would be a participant in the plan ("**CAT Participant**") and would jointly own CAT NMS, LLC on an equal basis. The CAT Plan includes a description of the process that would be used to select the initial plan processor. The CAT Plan also sets forth the requirements for data recording and reporting by the CAT Participants and industry members. *See* http://www.sec.gov/divisions/marketreg/cat-nms-agreement.pdf (initially proposed CAT Plan); http://www.sec.gov/divisions/marketreg/cat-nms-plan-02-27-15.pdf (revised CAT Plan).

(8) In light of the remaining procedural, rulemaking and implementation stages, it will likely be several years before the CAT is fully implemented. Indeed, on April 14, 2015, Commissioner Kara Stein noted during a speech that the "development of the CAT has been bogged down by administrative hurdles . . . and implementation is still years away." *See* Commissioner Kara M. Stein, *The Dominance of Data and the Need for New Tools: Remarks at the SIFMA Operations Conference* (Remarks at the SIFMA Operations Conference, Apr. 14, 2015). However, in early 2016, Stephen Luparello, the Director of the SEC's Division of Trading and Markets, indicated that the CAT plan may be approved sometime in 2016, which would trigger a timeline requiring the SROs to begin submitting data to the CAT as early as late 2017. See John McCrank, *'Flash Crash' audit trail on track for late 2017: SEC official* (Reuters Feb. 9, 2016), available at

http://www.reuters.com/article/us-sec-regulations-audittrail-idUSKCN0VI1PI.

(9) FINRA has filed with the SEC a proposed rule change to amend FINRA Rules 7410 and 7440 to require FINRA members to identify on their Order Audit Trail System reports the identity of certain broker-dealers that are not FINRA members when the member has received an order from such broker-dealer. *See* Exchange Act Release No. 77180 (Feb. 19, 2016).

(g) **MIDAS and SEC Equity Market Structure Information Website**. In January 2013, the SEC staff began operating the Market Information Data Analytics System ("**MIDAS**"). MIDAS captures all orders posted on the national equity exchanges, all modification and cancellation of those orders, all trade execution of those orders, and all off-exchange executions. It is intended to help the SEC staff monitor market activity. On October 9, 2013, the SEC unveiled a new website (http://www.sec.gov/marketstructure) through which the SEC will share with the public data, research and analysis drawn from MIDAS. Some of the information made publicly available on the new website is not otherwise generally available to the public, including, for example, ratios related to the number and volume of orders that are canceled instead of traded and percentages of on-exchange trades and volume that are the result of hidden orders. *See* SEC Press Release 2013-217 (Oct. 9, 2013).

B. Technology Failures and Response.

1. Technology Failures. High profile technology failures have kept regulators focused on market infrastructure and systems issues.

(a) **BATS IPO Problems**. On March 23, 2012, technology problems caused BATS to cancel its planned IPO. *See generally* Press Release, BATS Global Markets, Inc. (Mar. 25, 2012).

(b) **NASDAQ Facebook IPO Problems**. On May 18, 2012, NASDAQ experienced technology problems in its handling of Facebook's IPO, causing a delay in the start of Facebook trading and large-scale confusion as to the status of customer orders. *See generally* Press Release, NASDAQ OMX, *NASDAQ OMX and NASDAQ Stock Market Boards Announce Program for Voluntary Accommodations Related to Facebook IPO Cross* (June 6, 2012).

(c) **Knight Trading Loss**. Due to a software problem, Knight submitted a series of unintended orders on August 1, 2012, resulting in an estimated trading loss of $440 million. *See generally* Press Release, Knight Capital Group, *Knight Capital Group Provides Update Regarding August 1st Disruption to Routing in NYSE-listed Securities* (Aug. 2, 2012).

(d) **NASDAQ SIP Outage**. On August 22, 2013, NASDAQ OMX halted trading in NASDAQ-listed securities for three hours after becoming aware that the Securities Information Processor ("**SIP**") could not process quotes. *See* NASDAQ OMX Release, *NASDAQ OMX Provides Updates on Events of August 22, 2013* (Aug. 29, 2013).

(e) **Other Exchange Outages**. Other recent events include a four-hour trading suspension on the NYSE on July 8, 2015 due to an "internal technical issue"; a three-hour outage on BATS' BYX exchange on September 26, 2013; a six-minute outage in one of NASDAQ OMX's quote dissemination channels of the SIP on September 4, 2013; an "internal systems issue" that caused a three-hour delay in the opening of options trading on CBOE on April 25, 2013. *See* Bradley Hope and Saumya Vaishampayan, Wall Street Journal, *Glitch Freezes NYSE Trading for Hours* (July 8, 2015); BATS Alerts, *BATS BYX Exchange Post Mortem* (Sept. 26, 2013); NASDAQ OMX Release, *NASDAQ OMX Updates Statement on the Securities Information Processor* (Sept. 4, 2013); CBOE Holdings Statement on Today's Trading Issue (Apr. 25, 2013).

2. Regulatory Responses.

(a) **SEC Meeting with Leaders of the Exchanges**. On September 12, 2013, SEC Chair White issued a statement after meeting with leaders of the equities and options exchanges, FINRA, DTCC and the Options Clearing Corporation in response to the NASDAQ SIP outage. She stated, in part, "[i]n short order, I also want those at the meeting—with the input of other market participants—to identify a series of concrete measures designed to address specific areas where the robustness and resilience of market systems can be improved, including the systems that were at the core of last month's trading interruption." The SEC press release also stated that the relevant parties in consultation with other market participants will, among other things: provide comprehensive action plans that address the standards necessary to establish highly resilient and robust systems for the SIPs, including testing standards and disclosure protocols; review their rules relating to the trade break process and procedures to reopen trading following a trading halt, and provide amendments to those rules as necessary; and provide rule amendments to implement "kill switches" that would allow exchanges to shut down trading in the event of technological failures, and review and consider other potential risk mitigation mechanisms. *See* SEC Press Release 2013-178 (Sept. 12, 2013).

(b) **New York Stock Exchange "Kill Switch."** On December 12, 2013, the New York Stock Exchange filed an immediately effective rule change with the SEC making available to its members optional risk management tools, including a "kill switch," to facilitate blocking of a member's orders where certain trading thresholds are met and supplement a member's own risk management procedures. *See* Exchange Act Release No. 71164 (Dec. 20, 2013).

Other exchanges have subsequently begun providing similar tools. For example, in October 2015, the SEC approved a NASDAQ OMX BX rule change that provides exchange participants with an optional "kill switch" to remove quotes, cancel orders and prevent the submission of new quotes and orders. *See* Exchange Act Release No. 76116 (Oct. 8, 2015).

(c) **Options Exchanges' Response**. The options exchanges have also responded to SEC Chair White's call to action. *See* discussion in Section III.G below.

(d) **Regulation SCI**. On November 19, 2014, the SEC adopted Regulation Systems Compliance and Integrity ("**Regulation SCI**"), a set of rules designed to strengthen the technology infrastructure of the markets by replacing and building on the SEC's voluntary Automation Review Policy. Regulation SCI applies to the national securities exchanges, operators of certain ATSs, FINRA, securities information processors, each registered and one exempt clearing agency and the Municipal Securities Rulemaking Board (the "**SCI Entities**"). Regulation SCI sets forth requirements on, among other things, systems integrity and security, systems compliance, responses to systems compliance and integrity ("**SCI**") events, notification of systems changes, the annual SCI review, business continuity testing and recordkeeping. Specifically, each SCI Entity must, among other things: (1) implement reasonably designed written policies and procedures to ensure that its SCI systems are able to maintain the SCI Entity's operational capabilities and promote fair and orderly markets; (2) implement reasonably designed written policies and procedures to ensure that its SCI systems operate in a manner that complies with the Exchange Act and the rules thereunder as well as the SCI Entity's own rules; (3) in the event of a systems disruption, take corrective action, provide the SEC with immediate notice as well as detailed status updates, and promptly disseminate information and provide updates to the SCI Entity's affected members or participants; (4) provide the SEC with a quarterly report on Form SCI; (5) conduct an annual review of compliance with Regulation SCI; and (6) annually test its business continuity and disaster recovery plans. Regulation SCI became effective on February 3, 2015. *See* Exchange Act Release No. 73639 (Nov. 19, 2014).

(e) **FINRA Initiatives**. FINRA has advanced a number of regulatory initiatives concerning high frequency trading and equity market transparency. On September 19, 2014, FINRA's Board of Governors approved a series of market structure initiatives, announcing that FINRA would, among other things, provide guidance relating to the supervision of algorithmic trading strategies and solicit comment on proposals concerning, for example, the registration of personnel involved in developing algorithmic trading strategies and the expansion of its alternative trading system transparency rule to include OTC trading. *See* Update: FINRA Board of Governors Meeting (Sept. 19, 2014), *available at* https://www.finra.org/industry/update-finra-board-governors-

meeting-91914. FINRA has already taken action on several of these initiatives. For instance, FINRA issued a Regulatory Notice on March 19, 2015 soliciting comment on a proposal to require the registration of persons who are primarily responsible for the design, development or significant modification of algorithmic trading strategies or those supervising such activities. It has also issued guidance concerning the supervision and control practices for the development and deployment of algorithmic trading programs. *See* FINRA Regulatory Notices 15-06 and 15-09. On February 11, 2016, FINRA filed with the SEC a proposed rule change that would require the registration as Securities Traders of associated persons primarily responsible for the design, development or significant modifications of algorithmic trading strategies or who are responsible for the day-to-day supervision or direction of such activities. *See* Exchange Act Release No. 77175 (Feb. 18, 2016).

(f) **Exchange Initiatives**. In response to the technical glitch that suspended trading on the NYSE for four hours on July 8, 2015, the NYSE and NASDAQ OMX Group Inc. announced that they are planning an arrangement to "back up" each other's closing auctions in the event that an exchange outage affects the close on either exchange. Bradley Hope and Dan Strumpf, Wall Street Journal, *NYSE, Nasdaq Planning Pact to Back up Each Other's Closing Auctions* (July 22, 2015).

C. August 24, 2015 Market Volatility. The U.S. equity markets and equity-related futures markets experienced unusual price volatility on August 24, 2015, particularly prior to and around the opening of U.S. markets. One national securities exchange that incorporates a manual element into its opening process was unable to open all of its listed stocks for trading at 9:30 a.m., while many exchange-traded funds traded at prices that did not reflect their underlying net asset value. These and other events of the day have led to questions regarding, among other things, listing exchange opening processes, the effectiveness of the limit-up limit down mechanism, the effectiveness of the current market-wide circuit breakers, and the impact of these mechanisms and volatility on the trading of exchange-traded funds. *See*, *e.g.*, Staff of the Office of Analytics and Research, SEC, Research Notes: Equity Market Volatility on August 24, 2015.

D. Other Key Market Structure Issues and Areas of Focus.

1. Dark Pools. The SEC has considered, though not yet taken action on, a November 13, 2009 proposal (the "**Dark Pools Release**") to increase the transparency of dark pools and mitigate fragmentation. *See* Exchange Act Release No. 60997 (Nov. 13, 2009). In addition, the SEC raised certain issues relating to dark pools in its Concept Release on Equity Market Structure (the "**2010 Concept Release**"). *See* Exchange Act Release No. 61358 (Jan. 14, 2010).

(a) **Hidden Quoting**. The Regulation NMS construct is that quotes and customer limit orders of exchanges and OTC market makers must be displayed in the public quotation stream (operated by CTA/CQ and NASDAQ) unless the orders and quotes are dark, *i.e.*, displayed only to one other person.

However, limit orders and quotes on an ATS can be displayed within the ATS system and to others without being displayed in the public quotation stream until the ATS executes more than 5% market share in the particular stock that is quoted.

(1) **Indications of Interest**. The SEC staff has long worried that indications of interests ("**IOIs**") are used to circumvent the quoting requirements. The quote rule excepts IOIs from the general requirement that quotes be displayed to the public. *See* Rule 600. The Dark Pools Release proposed to amend the definition of bid or offer to only exclude IOIs that are not actionable. Under the proposal, if an IOI explicitly or implicitly communicates enough information on which to base a response, and by its terms or by consistent practice the IOI can be executed against, it would be viewed as an order, not an IOI, under Regulation ATS. The test would be essentially whether the IOI effectively represents a firm quote. If the IOI is viewed as a quote or order, then it would be subject to the display requirement thresholds under Regulation ATS.

(i) The proposed rule would except IOIs of $200,000 or more that are communicated only to those who are reasonably believed to represent current contra-side trading interest of at least $200,000.

(2) **Quoting Threshold**. Questions also have been raised whether the 5% threshold for inclusion of ATS quotes in the public quotation stream should be lowered.

(i) The Dark Pools Release proposed to lower the volume threshold for inclusion of ATS quotes in the public quotation stream to 0.25%.

(A) As a means of promoting liquidity for large orders, the SEC also proposed to provide an exception from the ATS quote requirement for quotes for $200,000 or more communicated only to those who are reasonably believed to represent current contra-side trading interest of equally large size.

(B) The 2010 Concept Release requested comment on whether the trading volume threshold in Regulation ATS that triggers fair access requirement should be lowered from 5%.

(ii) Exchanges have argued that ATS quotes should be included in the quote stream without a market share threshold

since exchange quotes are required to be made publicly available and included in the public quotation stream irrespective of volume levels.

(iii) OTC market maker quotes in listed stocks must be made available at a 1% market share threshold.

(b) **Opaque Transaction Reporting**. The SEC staff had stated concerns that ATS trade reporting practices made it difficult for the public to assess dark pool trading volume and evaluate which dark pools may have liquidity in particular stocks. The Dark Pools Release proposed to require that the real-time post-trade execution reports disseminated to the public include the identity of the individual ATS where the trade was executed. As noted below, some of these concerns have been addressed by new FINRA transparency rules.

(1) **Dark Pools Release**.

(i) **Market Identifiers**. Post-trade ATSs report their transactions to a Transaction Reporting Facility ("**TRF**") operated by NASDAQ or the NYSE in conjunction with FINRA, or to FINRA's own TRF (the Alternative Display Facility, or "**ADF**"). These ATS trades are recorded generically as having occurred "over-the-counter." Each ATS trade is reported individually by the TRF to the consolidated transaction reporting systems and is publically disseminated by the CTA or NASDAQ with the identifier of the particular TRF.

(A) While many market participants know where the larger ATSs report their trades, some ATSs split their reports between TRFs, and TRFs commonly receive trade reports from multiple reporting entities. As a result, it was difficult to ascertain the trading volume of a particular ATS from public TRF transaction reports.

(B) Trade reporting is a concern for ATSs that principally trade blocks for institutions that may not have completed a block transaction on the ATS when pieces of the block are reported. Identifying on trade reports that a trade was executed by a block trading ATS may disclose that a block is being executed, moving the market in a way that impairs execution of the block.

(ii) **Reporting Conventions**. Many ATSs, including dark pools, historically made their trading volume statistics available on their websites or to third-party research firms; however, these statistics were not standardized. For example,

some ATSs double-counted buy and sell orders that were crossed as a single trade, or included trades that were routed away from the ATS as part of the ATS' volume. Therefore, ATS reporting data required substantial interpretation before the trading volumes of multiple ATSs could be compared.

(iii) **Real-Time Disclosure**. The Dark Pools Release proposed to require real-time disclosure of "the identity of individual ATSs on trade reports in the public data stream, in the same way exchange trades are identified." As with other proposals in the release, block-size trades of $200,000 or more would have been excepted from this requirement. The SEC did not propose to require the trades of OTC market makers to be individually identified.

(2) **FINRA Reporting and Disclosure**. Responding to some of the concerns noted above, on January 17, 2014, the SEC approved FINRA Rule 4552, which required ATSs to report their volume information to FINRA for publication to the public on a delayed basis. *See* Exchange Act Release No. 71341 (Jan. 17, 2014). The rule became effective on May 12, 2014.

(i) Under FINRA Rule 4552, ATSs had to report to FINRA the aggregate weekly volume information and number of trades, by security, within the ATS, using a unique MPID for the ATS. The manner of reporting was standardized so as to ensure consistency across ATSs, allowing for cross-ATS comparisons (*e.g.*, excluding double counting and counting of orders routed out).

(ii) FINRA published on its website (https://ats.finra.org) the information reported by each ATS, with information regarding more liquid stocks (those in the S&P 500 or Russell 1000 indices, and certain exchange-traded products) subject to a two-week delay, and the remainder subject to a four-week delay. In October 2015, the SEC approved a rule change to expand the information published on FINRA's website to include the non-ATS OTC equity volume by member firm and security. *See* Exchange Act Release No. 76078 (Oct. 5, 2015).

(iii) Subsequently, FINRA found that ATS volume information that is derived from trade reports submitted to FINRA's trade reporting facilities generally contain fewer errors than self-reported ATS data. As a result, FINRA amended its rules so that, effective February 9, 2016, ATSs were no longer required to calculate weekly equity aggregate trade volume and

submit it to FINRA under Rule 4552. Instead, FINRA has begun disseminating ATS volume information based on trade reporting data. *See* Exchange Act Release No. 76931 (Jan. 19, 2016).

(c) **Dark Pool Enforcement Actions**. The SEC has recently taken enforcement action against several dark pools (and other ATSs) for alleged violations of Regulation ATS and other rules.

(1) On October 24, 2011, the SEC took enforcement action against Pipeline Trading Systems, alleging that it violated antifraud rules and Regulation ATS obligations by failing to disclose to subscribers or describe in its Form ATS that the vast majority of trades executed in the dark pool were with an affiliate of the dark pool operator in its proprietary capacity, rather than unrelated customers. *See* Exchange Act Release No. 65609 (Oct. 24, 2011).

(2) On January 15, 2015, the SEC took enforcement action against UBS Securities LLC, alleging that it violated Regulation NMS by offering an order type on its dark pool that enabled certain subscribers to buy and sell securities by placing orders priced in increments of less than one cent, which enabled the users of the order type to place sub-penny-priced orders that jumped ahead of other orders submitted at legal, whole-penny prices. The SEC also found that UBS violated Regulation ATS by failing to disclose and unreasonably prohibiting subscribers from using a "natural-only crossing restriction" that was developed to ensure that select orders would not execute against orders placed by market makers and high-frequency trading firms. *See* Exchange Act Release No. 74060 (Jan. 15, 2015).

(3) On August 12, 2015, the SEC took enforcement action against ITG Inc. and its affiliate AlterNet Securities, alleging that ITG operated an undisclosed proprietary trading desk known as "Project Omega," while representing to the public that it was an "agency-only" broker whose interest did not conflict with its customers. The SEC also alleged that during an eight-month period Project Omega accessed live feeds of order and execution information of ITG's dark pool subscribers and used that information to implement high-frequency algorithmic trading strategies, including one that traded against the dark pool subscribers. *See* Exchange Act Release No. 75672 (Aug. 12, 2015).

(4) On January 31, 2016, the SEC took enforcement action against Barclays Capital Inc., alleging that Barclays, among other things: (i) misrepresented its efforts to police its ATS, (ii) failed to disclose adequately its ATS' practice of overriding one of its advertised tool's categorization of subscribers and (iii) misrepresented the type and number of market data feeds that its ATS used to calculate the NBBO.

The New York Attorney General also took parallel action against Barclays. *See* Exchange Act Release No. 77001 (Jan. 31, 2016).

(5) The SEC also took two separate ATS enforcement actions on January 31, 2016 against Credit Suisse Securities (USA) LLC—one relating to Credit Suisse's "Crossfinder" dark pool, and another relating to Credit Suisse's "Light Pool" ECN (*i.e.*, its ATS that, unlike a dark pool, publicly displayed its quotations). According to the SEC's orders, Credit Suisse, among other things: (i) accepted, ranked and executed millions of illegal sub-penny orders in Crossfinder in violation of Rule 612 of Regulation NMS; (ii) failed to inform subscribers that Credit Suisse's order router prioritized Crossfinder over other venues in certain stages of its dark-only routing process; and (iii) misrepresented that it would use Alpha Formula to identify "opportunistic" traders and eliminate them from Light Pool. The New York Attorney General also took parallel action against Credit Suisse. *See* Exchange Act Releases Nos. 77002 (Jan. 31, 2016) and 77003 (Jan. 31, 2016).

(6) Several of the SEC's enforcement actions have focused on ATS operators' failure to safeguard confidential trading information.

(i) On October 3, 2012, the SEC took enforcement action against eBX, the operator of the LeveL ATS dark pool, alleging that it violated Regulation ATS by failing to protect the confidentiality of its subscribers' trading information. Specifically, the SEC alleged that LeveL allowed a third-party service provider that assisted in the operation of the ATS to use information about unexecuted customer orders resting in the dark pool to benefit the service provider's unrelated order routing business. *See* Exchange Act Release No. 67969 (Oct. 3, 2012).

(ii) On June 6, 2014, the SEC took enforcement action against Liquidnet, Inc., the operator of a dark pool, for improperly using its subscribers' confidential trading information in marketing its services. Specifically, the SEC alleged that Liquidnet allowed a business unit outside of its dark pool operation to access confidential trading data and to use the data during marketing presentations and in communications with its other customers. *See* Exchange Act Release No. 72339 (June 6, 2014).

(iii) On July 25, 2014, the SEC took enforcement action against LavaFlow, Inc., a former business unit of Citigroup that operated an ECN, alleging that it failed to protect the confidential trading data of its subscribers. The SEC alleged that LavaFlow allowed an affiliate operating a smart order router

to access and use confidential information related to the non-displayed orders of LavaFlow's ECN subscribers. *See* Exchange Act Release No. 72673 (July 25, 2014).

(7) In addition to SEC enforcement actions, other regulators have also focused on activities occurring in dark pools.

(i) On June 25, 2014, the New York Attorney General filed civil fraud charges against Barclays Capital, Inc. and Barclays PLC, alleging that Barclays falsely represented the concentration of high frequency traders in its dark pool. The New York Attorney General also alleged that Barclays falsified marketing materials and misrepresented services that purported to protect investors from predatory trading behavior. *See* Amended Complaint, *The People of the State of New York v. Barclays Capital, Inc., and Barclays PLC*, 451391/2014 (Sup. Ct. N.Y. County filed Jan. 21, 2015). Barclays has denied the allegations and is litigating the suit. *See* Christian Dolmetsch, Bloomberg, *Barclays Asks Judge to Throw Out New York Dark Pool Suit* (Dec. 18, 2014).

(ii) On July 1, 2014, FINRA announced that it had fined Goldman Sachs Execution & Clearing, L.P. for its alleged failure to have reasonably designed written policies and procedures in place to prevent trade-throughs of protected quotations in NMS stocks traded in its dark pool, SIGMA-X. Specifically, FINRA found that, from July 29, 2011 through August 9, 2011, more than 395,000 transactions were executed in SIGMA-X where the execution traded through a protected quotation at a price inferior to NBBO. The trade-throughs were caused by market data latencies at SIGMA-X and were not detected in a timely manner. *See* FINRA Letter of Acceptance, Waiver and Consent No. 20110307615-01 (June 30, 2014).

(d) **Market Fragmentation**. The SEC and many market participants have raised concerns regarding market fragmentation for many years.

(1) For example, in a 2000 release (Exchange Act Release No. 42450 (Feb. 23, 2000)), the SEC proposed the following potential options for addressing fragmentation:

(i) Requiring greater disclosure by market centers and brokers concerning the quality of trade executions and order routing practices (this was implemented by adoption of the execution quality statistics rules, Rules 605 and 606 of Regulation NMS);

(ii) Restricting internalization and payment for order flow (this was indirectly addressed by trading in pennies);

(iii) Requiring exposure of market orders to price competition;

(iv) Adopting an intermarket prohibition against market makers trading ahead of previously displayed and accessible limit orders;

(v) Providing intermarket time priority for limit orders or quotations that improve the NBBO; and

(vi) Establishing price/time priority for all displayed trading interest (this was partially implemented in Regulation NMS by providing for price priority for displayed quotes).

(2) The SEC addressed the issue of market fragmentation in its 2010 Concept Release. The 2010 Concept Release requested comment on whether the SEC should consider a trade-at rule that would prohibit any trading center from executing a trade at the price of the national best bid and offer unless the trading center was displaying that price at the time it received the incoming contra-side order. The 2010 Concept Release also discussed potential expansion of the trade-through rule to provide trade-through protection to the displayed "depth-of-book" quotations of a trading center, which could also have significant competitive impact.

(3) Rule 606 of Regulation NMS currently requires some public disclosure of broker-dealer order routing practices. In general, the rule requires broker-dealers that route orders in NMS securities to make available quarterly reports that present certain required information concerning their order routing practices for non-directed orders. The rule also requires broker-dealers, upon customer request, to disclose to the customer the identity of the venue to which the customer's orders were routed for execution, whether the orders were directed orders or non-directed orders and the time of the transactions (if any) that resulted from such orders. Orders with large sizes, which are commonly used by institutional investors, are excluded from the rule.

(i) In her June 5, 2014 speech, Chair White noted that she had instructed the SEC staff to prepare a recommendation for a rule that would enhance order routing disclosures. The contemplated rulemaking proposal would address a perceived gap in Rule 606 by "requiring disclosure of the customer-specific information that a broker is expected to provide to each

institutional customer on request." *See* White June 5, 2014 Speech.

(ii) On October 23, 2014, the Investment Company Institute, Managed Funds Association and SIFMA submitted a proposed order routing disclosure template to the SEC that would provide for the minimum disclosure of order routing and execution quality information that institutional investors could request from their broker-dealers, which is intended to inform a potential SEC rulemaking in this area. *See* Letter from Dorothy M. Donohue, Deputy General Counsel, Investment Company Institute, Stuart J. Kaswell, General Counsel, Managed Funds Association, Randy Snook, Executive Vice President, SIFMA, to Mary Jo White, Chair, Securities and Exchange Commission (Oct. 23, 2014), *available at* www.ici.org/pdf/28480.pdf.

(e) **Unfair Access**. A fundamental premise of the national market system is that market participants should have the opportunity to participate in a market when it reaches a significant size. Accordingly, exchanges are required to provide fair access for broker-dealers to become members. Initially, Regulation ATS required ATSs to establish fair access procedures when they reached a 20% market share threshold. As part of the Regulation NMS adoption process, the SEC reduced the threshold for application of the ATS fair access requirements from a 20% to a 5% market share threshold. *See* Rule 301(b)(3)(iii).

2. High Frequency Trading. High frequency trading refers to automated trading through frequent orders driven by complex algorithms. Many firms that engage in high frequency trading seek to end the day with little or no exposure to the market. Speed of information flows and order flows is critical to high frequency trading firms. High frequency trading has been accelerating, and raises perceived issues of fairness. From a regulatory perspective, an array of issues arise in the context of high frequency trading, including: co-location, the risks of naked/sponsored access and the SEC's means of collecting information about the orders and transactions of large traders that are not necessarily registered broker-dealers, each of which the SEC has discussed in rule proposals or its 2010 Concept Release.

(a) **Flash Boys**. Public scrutiny and debate over the fairness and alleged abuses of high frequency trading was piqued in April 2014 with the release of Michael Lewis' book, *Flash Boys: A Wall Street Revolt*. The book alleges that many high frequency trading firms, exchanges, brokers and dark pools have engaged in practices that benefit high frequency traders to the detriment of other investors. These include allegations that high frequency trading firms may effectively "front run" other investors' orders by detecting their trading interest and then routing their own orders to trading venues faster, resulting in worse execution prices for those investors. The book also alleges

that exchanges' co-location services and proprietary market data feeds improperly allow high frequency trading firms to trade based on advanced information about the market prices prior to those updated prices being reflected in the public NBBO as disseminated by the SIP, essentially allowing other investors to trade based on stale quotes.

(b) **Investigations and Lawsuits**. Various federal and state regulators and law enforcement officials have announced that they are conducting investigations into high frequency trading practices and the role of various market participants. *See, e.g.*, Keri Geiger, Bloomberg, *High-Speed Traders Said to Be Subpoenaed in N.Y. Probe* (Apr. 17, 2014); Andrew Ackerman, Wall Street Journal, *SEC Investigations into High-Frequency Trading Under Way* (Apr. 1, 2014); Scott Patterson, Wall Street Journal, *FBI Investigates High-Speed Trading* (Mar. 31, 2014).

(1) In April 2014, the City of Providence, Rhode Island filed a purported class action lawsuit against various market participants and exchanges, alleging that the class of investors suffered losses as a result of improper conduct alleged in *Flash Boys*. *See* Complaint, City of Providence, *Rhode Island v. BATS Global Markets, Inc., et al.*, 14-CV-02811 (S.D.N.Y. filed Apr. 18, 2014). On June 18, 2015, Judge Jesse Furman of the Southern District of New York held oral arguments on the pending Motion to Dismiss, and on August 26, 2015, the Court issued an Opinion and Order granting the Defendant's Motion to Dismiss, dismissing the Complaint in full. Plaintiff filed a Notice of Appeal of the dismissal on September 24, 2015 and its appeal brief on January 7, 2016. Respondent's brief will be due on or before April 7, 2016.

(2) In October 2014, the SEC sanctioned Athena Capital Research for allegedly placing a large number of aggressive, rapid-fire trades in the final two seconds of almost every trading day during a six-month period to manipulate the closing prices of stocks. *See* Exchange Act Release No. 73369 (Oct. 16, 2014).

(c) **Rulemakings**. In her June 5, 2014 speech, SEC Chair White articulated an ambitious agenda of market structure rulemaking initiatives, several of which relate to high frequency trading, including: an anti-disruptive trading rule; a rule to clarify the status of unregistered active proprietary traders and subject them to dealer regulation; and a rulemaking to narrow the scope of Exchange Act Rule 15b9-1, which currently exempts certain limited business brokers-dealers from FINRA membership. *See* White June 5, 2014 Speech. On March 25, 2015, the SEC proposed amendments to narrow Rule 15b9-1. Currently, Rule 15b9-1 exempts a broker-dealer from FINRA membership if the broker-dealer is a member of a national securities exchange, carries no customer accounts and has an annual gross income of no more than $1,000

derived from securities transactions effected off-exchange (not counting income from trading with or through another broker-dealer). Under the SEC proposal, a broker-dealer would be exempt from FINRA membership if it is a member of a national securities exchange, carries no customer accounts and trades solely on an exchange of which it is a member. The proposal would provide for two narrow exceptions to the requirement that a broker-dealer trade solely on an exchange of which it is a member: (1) a broker-dealer that conducts business on the floor of an exchange could effect transactions off the exchange, for the dealer's own account with or through another registered broker-dealer, as long as such transactions are solely for the purpose of hedging the risks of its floor-based activities and certain conditions are satisfied; and (2) a broker-dealer could effect transactions off the exchange that result from orders that are routed by the exchange of which it is a member, to prevent trade-throughs on that exchange consistent with Rule 611 of Regulation NMS. *See* Exchange Act Release No. 74581 (Mar. 25, 2015).

3. Competition Issues Between Exchanges and Alternative Trading Systems. Exchanges and alternative trading systems, which compete with one another for order flow, have been engaged in a debate regarding whether the regulatory requirements governing each favor one set of competitors over the other. Regulation ATS exempts from exchange regulation those trading systems that: operate as broker-dealers, do not act as self-regulators and do not hold themselves out as exchanges. Registered exchanges, such as NYSE, have expressed the view that ATSs should be regulated in parity with exchanges, as the need to encourage ATS competition to exchange markets no longer exists. *See, e.g.*, NYSE Euronext Comment Letter, *available at* http://www.sec.gov/comments/s7-27-09/s72709-63.pdf.

(a) Advocates of the position that alternative trading systems have unfair regulatory advantages over exchanges have noted, among other things, that: (1) the public filing requirements relating to exchanges' rule changes put exchanges at a disadvantage compared to alternative trading systems, which are subject to only limited notice filings requirements for rule changes; (2) the fair access requirements imposed on exchanges are much broader than those imposed on alternative trading systems; and (3) exchanges are required to expend significant resources on market surveillance obligations, whereas alternative trading systems are free from such self-regulatory requirements. *See, e.g.*, Testimony of Duncan Niederauer, NYSE Euronext, House Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises, *Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors* (June 20, 2012).

(b) Advocates of the position that exchanges have unfair regulatory advantages over alternative trading systems have noted, among other things, that: (1) exchanges enjoy immunity from civil liability with respect to errors, a benefit not available to alternative trading systems; (2) exchanges earn significant profits

from rebates from the consolidated data tape, whereas alternative trading systems do not receive tape revenue; and (3) exchanges are not subject to capital requirements, whereas the operators of alternative trading systems (broker-dealers) are required to comply with various capital-related rules. *See, e.g.*, Testimony of Daniel Mathisson, Credit Suisse, House Financial Services Committee Subcommittee on Capital Markets and Government Sponsored Enterprises, *Market Structure: Ensuring Orderly, Efficient, Innovative and Competitive Markets for Issuers and Investors* (June 20, 2012); Letter from Theodore R. Lazo, Managing Director and Associate General Counsel, SIFMA, to Mary Jo White, Chair, SEC (July 31, 2013).

(c) **SEC Proposed Amendments to Regulation ATS.** One recent SEC proposal, if adopted as proposed, would result in certain ATSs being regulated in a manner more consistent with national securities exchanges regulations. Specifically, in November 2015, the SEC proposed amendments to Regulation ATS and related rules to impose extensive new transparency requirements on, and greatly increase the SEC's active oversight of the design of, ATSs that facilitate transactions in NMS stocks ("**NMS Stock ATS**"). *See* Exchange Act Release 76474 (Nov. 18, 2015). The proposal would require all NMS Stock ATSs to file, and obtain SEC approval of, a new Form ATS-N in order for the NMS Stock ATS to qualify for the exemption from registration as a national securities exchange. The proposal would require NMS Stock ATSs to publicly disclose certain detailed information about the activities of their broker-dealer operators (and their affiliates) and the operations of the ATSs themselves, including, for example: fees, rebates or other charges of the NMS Stock ATS, and any differences among subscribers in the services, procedures of functionalities that the NMS Stock ATS provides; types of orders, as well as their priority and operational rules and conditions; arrangements with operators of unaffiliated trading centers regarding access to the NMS Stock ATS; and trading by the broker-dealer operator or any of its affiliates on the NMS Stock ATS, as well as details regarding other business units' or affiliates' dealings on the NMS Stock ATS and whether other subscribers can be excluded from trading with such persons.

(d) **SEC Disapproval of NASDAQ Benchmark Order Plan**. Several of the competition issues between exchanges and alternative trading systems were relevant to the SEC's January 11, 2013 disapproval of a proposed NASDAQ Stock Market rule change to establish "Benchmark Orders." Under the proposal, NASDAQ would have offered "Benchmark Orders," which would seek to achieve the performance of a specified benchmark (*e.g.*, VWAP) over a specified period of time for a specified security. Upon receipt of such orders, NASDAQ would direct the orders to a system application licensed from a third-party provider. The system application would process Benchmark Orders by generating "child orders" and sending such child orders to the NASDAQ

matching engine or to the NASDAQ router as needed to complete the Benchmark Order. *See* Exchange Act Release No. 68629 (Jan. 11, 2013).

(1) In a comment letter urging the SEC to disapprove NASDAQ's proposal, SIFMA made several arguments relating to the larger debate regarding the regulatory requirements governing exchanges versus those governing alternative trading systems, including, among others, concerns that the proposal would give NASDAQ an inappropriate advantage over broker-dealers providing the same services in terms of the Market Access Rule and other regulatory requirements applicable to broker-dealers. *See* SIFMA Comment Letter, *available at* http://www.sec.gov/comments/sr-nasdaq-2012-059/nasdaq2012059-3.pdf.

(2) In its disapproval order, the SEC stated that the proposed rule change was not consistent with Exchange Act Sections 6(b)(5) and 6(b)(8). In reaching this finding, the SEC noted concerns about, among other things, whether (1) the child orders would be subject to adequate pre-trade risk checks and (2) NASDAQ responded adequately to concerns raised by SIFMA regarding whether regulatory immunity, or exchange rules limiting liability, in the context of NASDAQ's proposal to offer a service traditionally provided by broker-dealers, would impose an undue burden on competition under the Exchange Act.

(e) **NYSE Institutional Liquidity Program**. Competitive concerns between exchanges and ATSs also emerged in connection with the NYSE's proposed "Institutional Liquidity Program." The proposed program would create an order type to allow trading on the exchange of block-size orders or smaller child orders of block-size orders, without those orders being publicly displayed. In opposing the proposal, some commenters argued that the program would "blur the lines" between exchanges and dark pools. In supporting the proposal, the NYSE suggested that the program would allow it to more effectively compete with dark pools. The SEC instituted proceedings to determine whether the NYSE's proposed rule should be disapproved. *See* Exchange Act Release Nos. 71609 (Feb. 25, 2014) and 72205 (May 21, 2014). On June 27, 2014, the NYSE withdrew the proposed rule change. *See* Exchange Act Release No. 72512 (July 1, 2014).

(f) **Retail Liquidity Programs**. On July 3, 2012, the SEC approved the NYSE and NYSE Amex's (collectively, the "**NYSE**") proposed rule changes that establish a "Retail Liquidity Program." According to the NYSE, the Retail Liquidity Program is designed to attract additional retail order flow to the NYSE and to provide the potential for price improvement for retail orders. The program establishes a new class of market participants ("**Retail Member Organizations**") which would be able to submit a new type of order (a "**Retail Order**") to the

NYSE. Once a Retail Member Organization submits a Retail Order, another new class of market participants ("**Retail Liquidity Providers**") would be required to provide price improvement in the form of non-displayed interest that is better than the best protected bid or offer (a "**Retail Price Improvement Order**"). Other NYSE members would be allowed, but not required, to submit Retail Price Improvement Orders. Since the program would involve NYSE accepting and ranking non-displayed Retail Price Improvement Orders using increments less than the minimum pricing increment, NYSE requested and was granted exemptive relief from the "Sub-Penny Rule" of Rule 612 of Regulation NMS. *See* Exchange Act Release No. 67347 (July 3, 2012). BATS and the NASDAQ Stock Market have each also received SEC approval to establish Retail Price Improvement Programs. *See* Exchange Act Release No. 68303 (Nov. 27, 2012), Exchange Act Release No. 68937 (Feb. 15, 2013).

(g) **Reassessing Maker-Taker Fee Structures and Access Fees**.

(1) Many market centers and market participants have been reviewing the implications of various fee arrangements, including "maker-taker" pricing systems. For example, on December 30, 2014, the NASDAQ Stock Market filed with the SEC a proposed rule change that would both reduce the fees assessed on members that access liquidity from the exchange and reduce the credits provided to members that add liquidity to the exchange—all with respect to certain securities. According to NASDAQ, the changes "may improve price discovery in the select securities" and "will generate much-needed data about the impact of access fees on the level of off-exchange trading and, potentially, on price discovery, trading costs, displayed liquidity and execution quality as well." *See* Exchange Act Release No. 73967 (Dec. 30, 2014).

(2) In December 2014, the Wall Street Journal reported that the owner of the NYSE, Intercontinental Exchange Inc., circulated a draft letter to several large banks and other financial institutions proposing a "grand bargain" between exchanges, on the one hand, and ATSs and internalizing broker-dealers, on the other hand. Under the proposal, among other things, the NYSE would reduce its fees from 30 cents per 100 shares to 5 cents per 100 shares, and ATSs and broker-dealers would accept a "trade-at rule" that would prohibit any trading center from executing a trade at the price of the national best bid and offer unless the trading center was displaying that price at the time it received the incoming contra-side order. *See* Bradley Hope and Scott Patterson, Wall Street Journal, *NYSE Plan Would Revamp Trading* (Dec. 17, 2014).

(3) In January 2015, BATS Global Markets, Inc. submitted a rulemaking petition to the SEC that requested: (1) an amendment to Rule 610(c) of Regulation NMS to provide for tiered access fees starting at five-tenths of a cent per share; (2) an amendment to Rules 605 and 606 of Regulation NMS to provide additional order execution disclosures on a broker-dealer-by-broker-dealer basis; (3) a rulemaking to require all ATSs to provide their customers with their rules of operation; and (4) amendments to the definition of a protected bid or offer in Rule 600(b)(57) of Regulation NMS and the consolidated tape plans to provide that until an exchange or other currently protected market center achieves greater than 1% of consolidated average daily volume in any rolling three-month period, they should (i) no longer be protected under the trade-through rule (Rule 611 of Regulation NMS) and (ii) not share in or receive any NMS plan market data revenue. *See* Letter from Joe Ratterman, CEO, BATS Global Markets, Inc., to Brent Fields, Secretary, SEC (Jan. 21, 2015), *available at* http://www.sec.gov/rules/petitions/2015/petn4-680.pdf.

(h) **Market Maker Incentive Programs**. Several notable market maker incentive programs have recently been contemplated. For example, some exchanges have proposed controversial rule amendments that would allow certain issuers of exchange-traded products listed on the exchange to pay market makers to support trading in their securities. The proposals are generally intended to incentivize firms to take on certain market maker designations with respect to a security and to foster liquidity and stability in the market for the security. The proposals are particularly controversial in light of FINRA Rule 5250 (which prohibits payment for market making) and Rule 102 of Regulation M (which prohibits, in connection with a distribution of securities, issuers, selling security holders and their affiliated purchasers from directly or indirectly bidding for, purchasing or attempting to induce others to bid for or purchase covered securities during the applicable restricted period). *See, e.g.*, Exchange Act Release No. 66966 (May 11, 2012) (NYSE Arca's notice of filing of proposed rule change relating to its proposed Lead Market Maker Issuer Incentive Program) (withdrawn on Jan. 10, 2013).

(1) On June 6, 2013, the SEC approved NYSE Arca's proposed rule change to implement the NYSE Arca ETP Incentive Program, which is a one-year pilot program for issuers of certain exchange-traded products ("**ETPs**") listed on NYSE Arca. The program is intended to enhance the market quality for certain lower volume ETPs participating in the program by incentivizing NYSE Arca market makers to take Lead Market Maker ("**LMM**") assignments in such ETPs by offering an alternative fee structure for such LMMs. In particular, market makers will be eligible to receive quarterly payments if they satisfy certain requirements, including quoting requirements that are

higher than the standard quoting requirements otherwise applicable to NYSE Arca market makers. *See* Exchange Act Release No. 69706 (June 6, 2013). The SEC has twice extended the pilot program, which is now effective through September 4, 2016. *See* Exchange Act Release Nos. 72963 (Sept. 3, 2014) and 75846 (Sept. 4, 2015).

(i) **Other Enforcement Actions Against Exchanges**. Other recent SEC enforcement actions against exchanges also demonstrate the SEC's increased focus on market structure.

(1) On June 11, 2013, the SEC took enforcement action against CBOE and the C2 Options Exchange, alleging that the exchanges failed to fulfill their responsibilities as SROs and exchanges by, among other things, failing to enforce the SEC's short sale rules and their own exchange rules. *See* Exchange Act Release No. 69726 (June 11, 2013).

(2) On May 1, 2014, the SEC took enforcement action against the NYSE, NYSE Arca and NYSE MKT LLC and the exchanges' affiliated routing broker, Archipelago Securities. According to the SEC, the exchanges repeatedly engaged in practices that either violated exchange rules or required a rule when the exchanges had none in effect. For example, the SEC's order found that the NYSE provided co-location services to customers on disparate contractual terms without an exchange rule in effect that permitted and governed the provision of such services on a fair and equitable basis, and the NYSE distributed an automated feed of closing order imbalance information to its floor brokers at an earlier time than was specified in its rules. *See* Exchange Act Release No. 72065 (May 1, 2014).

(3) On January 12, 2015, the SEC took enforcement action against EDGA Exchange and EDGX Exchange, alleging that the exchanges' rules did not completely and accurately describe certain order types being used on the exchanges. The exchanges' rules provided for a single "displayed price sliding process" that was identified as the default for a non-routable order unless the member entered instructions not to use that process. However, according to the SEC, the process described in the exchanges' rules did not accurately describe how the functionality actually operated. In addition, according to the SEC, the exchanges also separately disclosed information about how the order types operated to some but not all of their members. *See* Exchange Act Release No. 74032 (Jan. 12, 2015).

4. JOBS Act and Tick Size. Section 106(b) of the Jumpstart Our Business Startups Act (the "**JOBS Act**") required the SEC to study the effects of decimalization on IPOs of small and middle capitalization companies and the liquidity and trading of such companies' securities.

(a) **SEC Staff Study**. In July 2012, the SEC staff published its study. The staff recommended that the SEC not proceed with rulemaking to increase tick sizes. Instead, the staff recommended that the SEC consider additional steps to determine whether rulemaking should be undertaken in the future. The staff suggested that the SEC solicit the views of investors, companies, market professionals, academics and interested parties on the broad topic of decimalization. *See* SEC Staff Report to Congress on Decimalization (July 2012).

(b) **SEC Roundtable**. On February 5, 2013, the SEC held a roundtable on decimalization to evaluate the impact of tick sizes on the securities markets. The first of three panels focused on the impact of tick sizes on small and mid-sized companies, the economic consequences (including costs and benefits) of increasing or decreasing minimum tick sizes, and policy alternatives. The second panel addressed the impact of decimalization on the securities market in general, including what benefits may have been achieved and what, if any, negative effects have resulted. The third panel considered methods for analysis of the issues, including whether and how to conduct a pilot for alternative minimum tick sizes. *See* Exchange Act Release No. 68510 (Dec. 21, 2012).

(c) **Tick Size Pilot Program**. In an October 2, 2013 speech, SEC Chair White stated, in part, "I have instructed the SEC staff to move forward on earlier efforts to work with the exchanges as they develop and, if possible, present to the Commission for its consideration a plan to implement a pilot program that would allow smaller companies to use wider tick sizes." SEC Chair Mary Jo White, *Focusing on Fundamentals: The Path to Address Equity Market Structure* (Remarks at the Security Traders Association 80th Annual Market Structure Conference, Oct. 2, 2013). On February 11, 2014, the U.S. House of Representatives passed a bill entitled the Small Cap Liquidity Reform Act which, if enacted, would require the SEC to implement a pilot program to test the effect of larger trading increments on the liquidity of certain issuers' securities. *See* H.R. 3448 (113th Cong.).

(1) In June 2014, the SEC ordered the stock exchanges and FINRA to jointly develop and file a proposal for a tick size pilot program. *See* Exchange Act Release No. 72460 (June 24, 2014).

(2) On August 25, 2014, the exchanges and FINRA filed with the SEC a proposed plan to implement a one-year pilot program that would widen the minimum quoting and trading increments for small capitalization stocks. The proposed pilot program would apply with respect to NMS stocks that have a market capitalization of $5 billion or less, an average daily trading volume of one million shares or less and a closing share price of at least $2 per share. The proposed pilot program would consist of one control group and three test groups with 400 securities in each test group selected by stratified sampling. *See*

Exchange Act Release No. 73511 (Nov. 3, 2014). On February 26, 2015, the SEC extended the time period for SEC action on the proposed pilot program to May 6, 2015. *See* Exchange Act Release No. 74388 (Feb. 26, 2015).

(3) On May 6, 2015, the SEC approved a modified version of the plan, providing for a two-year pilot program and reducing the market capitalization threshold for securities included in the pilot program from $5 billion to $3 billion. As with the proposed pilot, the approved pilot program consists of one control group of approximately 1,400 securities and three test groups with 400 securities in each. *See* Exchange Act Release No. 74892 (May 6, 2015).

(4) On November 6, 2015, the SEC issued an exemption that provides FINRA and the exchanges with additional time (until October 3, 2016) to complete their preparations for implementing the tick size pilot. *See* Exchange Act Release No. 76382 (Nov. 6, 2015).

5. Flash Orders. In 2009, controversy erupted over "flash orders," with critics claiming that flash orders provide an unfair advantage to those who see the flashed order to the exclusion of other investors, including retail investors, and proponents arguing that flash quotes are nothing more than the electronic version of practices that previously occurred throughout the equity markets. The controversy culminated in the SEC proposing to ban the use of "flash orders" on equities and options exchanges and large ATSs.

(a) **Background**.

(1) The term "flash orders" refers to a practice whereby a trading center will show participants of the trading center marketable orders of other participants for a few milliseconds, typically at the marketable quote price. Market participants with the requisite electronic connections can then execute the orders at the flash price or better. If the order is not immediately executed, it will be withdrawn without exposure to the entire marketplace.

(2) "Flash orders" have crystallized the concern of many observers that a "two-tiered" market is emerging. These concerns include the exposure of the order only to particular market participants rather than the entire public market and the potential for certain participants to view the flash order and trade ahead of it in the market, resulting in worse execution prices for the customer order.

(3) "Flash orders" also raise fragmentation concerns because they provide market participants the opportunity to selectively trade with

a flashed order without the need to publish a quote, while not providing displayed quotes the chance to trade with the order.

(4) On August 6, 2009, NASDAQ and BATS announced that they would voluntarily shut down their respective flash order systems on September 1, 2009. *See* Exchange Act Release Nos. 60569 (Aug. 26, 2009) (notice of BATS rule change) and 60570 (Aug. 28, 2009) (notice of NASDAQ rule change).

(5) In addition, in May 2009, FINRA issued a regulatory notice to remind member firms of their obligation to provide accurate information "when disseminating, or using services to disseminate, indications of interest to the marketplace." *See* FINRA Regulatory Notice 09-28.

(b) **The SEC Proposal**. In order to ban the use of "flash orders," the SEC has proposed amending the quote rule of Regulation NMS, requiring ATSs that have crossed the threshold for the public display of quotes to display flash orders, and deeming flash orders as orders that would violate Regulation NMS's prohibition on locking or crossing orders. Significantly, the release states that certain market mechanisms and order types, such as price improvement auctions and immediate or cancel orders, that bear some functional similarities to flash orders will not be affected by the proposal. *See* Exchange Act Release No. 60684 (Sept. 18, 2009).

(1) **Amendment to the Quote Rule**. The SEC proposes to eliminate paragraph (a)(1)(i)(A) of Rule 602 of Regulation NMS, which currently excludes from the requirement to display quotes "[a]ny bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication." As a result, under the proposal, flash orders on an exchange would need to be included in the exchange's public quote.

(2) **Display Requirements for Flash Orders on ATSs**. Rule 301(b)(3)(ii) of Regulation ATS provides that if an ATS has an average daily trading volume above 5% of the volume for an NMS stock, the ATS must submit its quotes in the stock to be included in the consolidated quote stream. The SEC's proposal would apply Rule 301(b)(3)(ii) to orders that either are immediately executed or withdrawn if not immediately executed, and that would otherwise be included in the consolidated quote stream under Rule 301(b). Therefore, under the proposal, an ATS would be required to send to the consolidated quote stream flash orders for stocks that the ATS is required to quote publicly.

(3) **Proposed Interpretation of Locked or Crossed Market Requirements**. Rule 610(d) of Regulation NMS requires national securities exchanges and associations to establish, maintain and enforce rules to reasonably avoid displaying "locking" or "crossing" quotations. If the amendment to Rule 602 is adopted, the SEC would consider the display of quotations that either are immediately executed or withdrawn if not immediately executed to be the display of quotations that are subject to Rule 610(d). Therefore, orders with marketable prices could not be flashed without being a locking or crossing order subject to Rule 610(d). The SEC would also adopt an interpretation of the locked and crossed markets provisions of the Linkage Plan for options that would have a similar result in the case of flash orders for listed options.

(4) **Reopening of Comment Period**. On July 2, 2010, the SEC reopened for 30 days the period for public comment on its flash ban proposal with respect to listed options. Some of the commenters that opposed the proposal with respect to listed options noted that, unlike in the cash equity markets, there is no regulatory cap on fees charged by listed options exchanges to access their best priced quotations and that access fees are significantly higher in the listed options markets than in the cash equity markets. Furthermore, commenters were concerned that elimination of the flash order exception could lead to even higher access fees for listed options. The SEC requested comments on, among other issues, the effect of a proposed cap on access fees for listed options and the execution quality for flash orders in the listed options markets. The SEC stated in its release that it is particularly interested in data on the extent to which flash orders, if they are not executed in the flash process, "miss the market" by receiving either an inferior price through an execution against a displayed quotation or no execution at all. *See* Exchange Act Release No. 62445 (July 2, 2010).

(c) **EDGX Step-up Order Proposed Rule Amendments and SEC Disapproval Proceedings**. On February 18, 2011, in an action that illustrates the SEC's continued efforts to minimize or eliminate the use of "flash orders," the SEC instituted proceedings to determine whether to disapprove EDGX Exchange, Inc.'s proposed rule change to amend its step-up order rules. EDGX Exchange defined a step-up order as a market or limit order with the instruction that the order be displayed to users at or within the NBBO price. The step-up orders were intended to permit a member of the exchange to initiate a price auction by displaying order solicitation information to other members simultaneously, provided the other members elected to receive such information. Under EDGX Exchange's rules at the time, the first responsive exchange member would execute against the step-up order. The proposed rule change would have, among other things, extended the step-up order display period to 10 milliseconds and would have executed responsive orders priced at or within the

NBBO on a price/time priority basis. In response to the SEC's institution of proceedings to determine whether to disapprove of the proposed rule change, EDGX Exchange withdrew the proposed rule change and ceased offering the step-up order. *See* Exchange Act Release Nos. 63930 (Feb. 18, 2011) and 64095 (Mar. 18, 2011).

III. Current Issues in the Options Markets.

A. Options Fragmentation and Internalization.

1. Unlike equities, trades in standardized options can only be executed on an exchange. As a result, there is no active OTC trading in standardized options. Several ATSs have developed to trade options through matching orders and executing them on an exchange.

2. Unlike futures, standardized options are issued and cleared by a single clearing agency, the Options Clearing Corporation, and are fungible across options exchanges. Thus, an options position purchased on one exchange can be offset and closed through sale of the same options series on another exchange.

(a) Although options had been traded by multiple exchanges before 1977, after its Special Study of the Options Markets in 1978, the SEC determined not to permit multiple trading of additional options on listed stocks. Instead, new options on listed stocks were allocated to an individual exchange pursuant to an Allocation Plan. Subsequently, the SEC allowed multiple trading on options on new products, including GNMAs, broad and narrow-based stock indices, Treasury securities, foreign currencies and over-the-counter equities.

(b) In May 1989, the SEC reversed its policy and adopted Rule 19c-5, which prohibited options exchanges from having rules that limit their ability to list any stock options class because that options class is listed on another options exchange.

(c) Thus, from January 20, 1990, each exchange was permitted to list any equity option that was being listed for the first time, *i.e.*, that had not been previously traded on any exchange. Multiple listing of equity options that were already being traded as of January 20, 1990 was phased in over a period of time ending in late 1994. Thus, by the end of 1994, each option exchange could list any equity option class.

(d) The SEC undertook these changes because it determined that competition among exchanges for options business would benefit investors by narrowing spreads.

(e) Following the adoption of Rule 19c-5, the four options exchanges adopted a joint plan to provide procedures for listing new equity options

("**Options Plan**"), which allowed each exchange to pre-announce its intention to list a new equity option class, established a 24-hour time frame for other exchanges to announce their intention to list the same option, and provided waiting periods before any exchange could start trading that option.

(f) In practice, however, competition in initial listed options did not develop, and many actively traded equity options were traded only on one exchange. No exchange faced ongoing competition on its options from another exchange, other than in the initial listing window, until the summer of 1999.

(g) Multiple trading began in earnest in the summer of 1999 as a result of two significant actions:

(1) In November 1998, the International Securities Exchange announced its intent to register as an options exchange and to engage in multiple trading of the most-actively traded options.

(2) In January 1999, the Department of Justice and SEC initiated investigations of the options exchanges for conspiring to limit multiple trading in options, in violation of Rule 19c-5. These actions were settled in September 2000, with an SEC censure of the four options exchanges, and a consent decree of the Justice Department.

(h) Beginning in August 1999, the then five options exchanges began trading options listed initially on another exchange, and soon almost all actively traded options became multiply traded.

3. The remaining actively traded options that are not multiply traded are options on indices subject to exclusive or preferential licensing arrangements. Because of licensing restrictions, these options are solely listed on one exchange. Some of these options are among the most actively traded options.

(a) In 2002, the International Securities Exchange petitioned the SEC to amend Rule 19c-5 to prohibit an options exchange from being a party to exclusive or preferential licensing arrangements with respect to index option products and options overlying other instruments, including options on securities whose value is based on an index. See http://www.sec.gov/rules/ petitions/petn4-469.htm. The SEC has not taken action on the petition.

(b) In September 2005, the SDNY held that two index providers, Standard & Poor's and Dow Jones, did not have a protectable property interest in options on the SPDRs and DIAMONDS ETFs based on their indices. *See McGraw-Hill Companies, Inc. v. Int'l Securities Exchange, Inc.*, and *Dow Jones & Co., Inc. v. Int'l Securities Exchange, Inc.*, consolidated as No. 05 Civ. 112 (HB), 2005 U.S. Dist. LEXIS 18674 (S.D.N.Y. Sept. 1, 2005), aff'd, 451 F.3d 295 (2d Cir. 2006).

4. Over the objections of commenters, the SEC originally adopted Rule 19c-5 without conditioning multiple trading on the development of an intermarket linkage like the ITS in the equity markets. However, as multiple trading developed, the SEC determined that the options exchanges would need to create systems to help ensure that customers receive best execution of their orders. Thus, the SEC issued an order requiring the exchanges to develop a linkage plan, and the exchanges implemented that linkage in 2000. *See* Exchange Act Release No. 42029 (Oct. 19, 1999).

5. Multiple trading of options resulted in benefits for customers, as well as pressures on exchanges to provide opportunities to order entry firms to trade with their orders. Concerns about the responses to these internalization pressures grew. In 2004, the SEC published a concept release to discuss the issues raised by these internalization pressures, in which it described the consequences of multiple trading. Exchange Act Release No. 49175 (Feb. 3, 2004).

(a) The SEC said that greater competition among options exchanges for order flow has manifested itself in many ways. Exchange transaction fees for customers have all but disappeared. Spreads are narrower. Markets have expanded and enhanced the services they offer and introduced innovations to improve their competitiveness. At the same time, inducements to order flow providers, including payment for order flow and internalization opportunities, have increased.

(b) In the release, the SEC sought comment on a range of potential responses to the internalization issues of options, but took no direct action to address the issues after the concept release was published.

6. Pressure on exchanges to accommodate internalization of orders by order entry firms or market makers who pay for order flow have continued. Although largely resisted by the SEC, a complicated web of rules allowing different degrees of interaction with customer orders has developed.

7. On July 1, 2011, the SEC approved a six-month pilot program proposed by BATS Exchange, Inc. that would allow buy and sell orders on options contracts to be directed to certain broker-dealers by particular market makers on BATS Options. The pilot program was heavily criticized in a letter to the SEC by the other eight options exchanges. On July 19, 2011, BATS withdrew its market maker plan, citing the need to address concerns that had been raised about the pilot program.

B. Decentralized Options Linkage Plan. On July 30, 2009, the SEC approved a revised options order protection and locked/crossed market plan for the options market. Exchange Act Release No. 60405 (July 30, 2009). Prior to the adoption of the revised plan, the options market was operating under the original options market linkage plan, which was adopted to minimize trade-throughs and to avoid a locked or crossed market. *See* Exchange Act Release No. 43086 (July 28, 2000). The revised plan was adopted in response to growth in the volume of options traded and the move towards quoting in pennies. In addition, the revised plan replaces

the original central linking mechanism with a decentralized structure. The revised plan also permits the use of intermarket sweep orders, which were not incorporated into the old plan. The revised plan in many ways tracks Regulation NMS.

1. Trade-Throughs. The revised plan requires each participant to establish, maintain and enforce written policies and procedures as approved by the SEC that are reasonably designed to prevent trade-throughs in all options series overlying a security or group of securities which class is available for trading on two or more exchanges that are participants in the plan. Each participant is required to conduct surveillance of its market on a regular basis to ascertain the effectiveness of the policies and procedures to prevent trade-throughs.

(a) The plan provides a number of exceptions for certain transactions from the prohibition against trade-throughs, and participants are required to establish, maintain and enforce written policies and procedures reasonably designed to assure compliance with the terms of the exception to the extent any exception is relied upon. Exceptions are included for systems issues, trading rotations, crossed markets, intermarket sweep orders, quote flickering, non-firm quotes, complex trades, customer stopped orders, price improvement and benchmark trades. These exceptions closely parallel the exceptions to the trade-through prohibition in Regulation NMS.

2. Locked and Crossed Markets. The revised plan requires each participant to establish, maintain and enforce written rules that require their members reasonably to avoid displaying locking or crossing quotes, and requires participants to have written rules that are reasonably designed to assure reconciliation of any lock or cross.

3. Implementation. The revised plan was implemented on August 31, 2009.

C. Penny Pilots.

1. Options markets, unlike equities markets, did not move to trading in pennies during the switch to decimalization. Instead, options priced at or above $3.00 traded in $.10 quote increments, and options priced under $3.00 traded in $.05 quote increments.

2. Option exchanges have long argued that moving to quotations in pennies would overwhelm the capacity of the vendors and firms to trade and process market data on options. They also have argued that trading in pennies would reduce liquidity at the quoted price, as occurred in the equities market. However, order driver exchanges argued that penny trading would reduce spreads and improve retail executions.

3. Beginning in early 2007, at the insistence of the SEC, the six options exchanges began quoting certain options (generally those priced below $3.00) in pennies on a pilot basis (the "**Penny Pilot Program**"). Certain market participants have argued that $1.00 is the right break point for quoting in pennies.

4. The Penny Pilot Program has expanded in phases. In December 2013, the options exchanges filed immediately effective rule changes with the SEC to extend the Penny Pilot Program through June 30, 2014. *See* Exchange Act Release No. 71105 (Dec. 17, 2013). The Penny Pilot Program was subsequently extended three times and is now authorized through June 30, 2016. *See* Exchange Act Release Nos. 72244 (May 23, 2014), 73686 (Nov. 25, 2014) and 75287 (June 24, 2015).

5. According to the International Stock Exchange, "there are no longer any actively traded symbols that are not in pennies." International Stock Exchange, Penny Pilot Analysis 15 (Sept. 2013).

D. Execution Quality Statistics for Options.

1. The SEC would like to see brokers base routing decisions more on execution quality and less on the receipt of payment for order flow. However, because of the complications of multiple series, the SEC did not apply its execution quality statistics rule, Rule 605 of Regulation NMS, to listed options, although its order routing disclosure rule, Rule 606, does apply to listed options.

2. In July 2008, SIFMA issued recommendations for improving the quality of execution reports for options exchanges.

3. Under the SIFMA proposal, data would be uniform, making comparison easier.

4. Brokers do not seem convinced that the data will have a major impact on routing.

5. It remains to be seen whether the SEC will engage in rulemaking activity, or if the SEC is satisfied with the industry's efforts.

E. Maker-Taker Fees for Options.

1. The equity market fee structure developed by ECNs of paying liquidity providers if their limit order is executed, and charging liquidity takers if they execute against displayed liquidity (so-called "**maker-taker fees**"), has expanded in the options markets, where maker-taker fees raise similar issues as in the equity markets.

(a) Rule 610(c) of Regulation NMS capped fees for taking liquidity for NMS stocks at $.003 but did not cap maker-taker fees for options.

(b) Options taker fees can be substantially higher than equity taker fees, including fees as high as $0.45.

(c) Options markets participants have railed against these fees.

2. In May 2008, Erik Sirri, then Director of the SEC Division of Trading and Markets, in a speech expressed sympathy for restraining excessive taker fees, and said they should not exceed a cent a contract. He also said that "SEC staff will continue to monitor developments in changes to the fee structures, and corresponding changes in behavior, in the options markets, to gauge the impact and see if further action is warranted." SEC Director, Division of Trading and Markets, Erik R. Sirri, *Remarks Before the 2008 Options Industry Conference* (May 2, 2008).

3. In July 2008, Citadel petitioned the SEC to institute a rulemaking proceeding to limit the fees that options exchanges may charge non-members to obtain access to quotations to $0.20 per contract. *See* http://www.sec.gov/rules/petitions/2008/petn4-562.pdf.

4. In April 2010, the SEC proposed capping access fees on the listed options market. *See* Section III.F below.

F. Options Market Access Fee Cap and Anti-Discrimination Rule. In 2010, the SEC issued a proposal that would cap exchange access fees for listed options and also prohibit exchanges from imposing unfairly discriminatory terms that inhibit access to quotations in listed options. This proposal would extend to listed options Rule 610(c) and Rule 610(a) of Regulation NMS, which currently apply only to listed stocks. *See* Exchange Act Release No. 61902 (Apr. 14, 2010).

1. The proposal may yield a number of options market structure benefits, including:

(a) limiting the extent to which exchange fees cause actual execution costs for listed options to differ from the exchanges' published quotations;

(b) rationalizing the operation of inter-market trade-through requirements (because exchange access fees are not included in the published quotation, some orders may be routed to another market even though, when the other market's fees are taken into account, the overall cost of execution is inferior to that on the market to which the order was sent in the first place);

(c) reducing the practical issues with banning flash orders in the options market, as proposed by the SEC (the disparity between actual execution cost and best priced quotations that results from unlimited exchange access fees, coupled with the complexity and diversity of exchange fee schedules, may result in an incentive for options markets to permit their members to use flash orders); and

(d) preventing an exchange from imposing unreasonably discriminatory fees on nonmembers seeking indirect access to the exchange's published quotations through a member.

2. However, the proposal would diminish the effectiveness of the maker-taker exchange model, in which some exchanges attract aggressively priced limit orders by paying rebates for posting quotations that are ultimately executed against, and finance those rebates through access fees. Ironically, this likely would encourage markets to compete for customer orders through exchange-sponsored payment for order flow programs, which many have criticized on public policy grounds.

3. In addition, the proposal could have an impact on the economics of offering exclusively licensed options or proprietary products that are available on only one exchange, as such products would be subject to the access fee cap.

G. Enhancement and Harmonization of Erroneous Trade Rules.

1. As noted, on the heels of the NASDAQ SIP outage and other technological mishaps—including, as discussed in Section II.A.2(a)(2)(v) above, a reported multimillion dollar loss sustained by Goldman Sachs because of erroneous options orders in August 2013—SEC Chair White met with the heads of the options exchanges and other SROs to discuss potential initiatives aimed at addressing market technology risks and resilience.

2. Prompted, in part, by Chair White's call to action, the options exchanges have been working together to identify ways to bring greater clarity and transparency to, and generally enhance, their error rules. To that end, the options exchanges have recently been proposing changes to, and harmonizing, their rules relating to the adjustment and nullification of erroneous options transactions. *See, e.g.*, Exchange Act Release No. 74556 (Mar. 20, 2015) (SEC approval of BATS Exchange rule changes relating to the adjustment and nullification of erroneous options transactions).

Annex A

Glossary of Selected Market Structure Terms

ATS refers to an "alternative trading system" that acts as a venue for trading securities and is subject to Regulation ATS. ATSs are typically electronic trading systems involving multiple parties (although manual interdealer broker systems are also ATSs). An ATS must be registered with the SEC as a broker-dealer and as an ATS. ATSs are subject to requirements for quoting, fair access, systems reliability and information confidentiality at differing thresholds of market share. ATSs cannot call themselves exchanges.

Circuit Breakers refers to rules that limit trading activity upon the occurrence of specified events. Market-wide circuit breakers, when triggered, halt trading in all exchange-listed securities throughout the U.S. markets. Single-stock circuit breakers, when triggered, halt trading in an individual security.

Co-location refers to the practice whereby exchanges, ATSs or third parties provide space for the servers of market participants in the same data center housing the matching engines of the trading center. Co-location is favored by high frequency traders because it affords lower latency in the transmission of the order from the trader to the market center.

Dark Pools refers narrowly to ATSs that do not display bids and offers in the public quotation stream. More broadly, the term Dark Pools refers to sources of liquidity not reflected in public quotes, such as dark orders on exchanges and internalization of orders by broker-dealers.

Decimalization refers to the transition from quoting stock prices in 1/16ths or 1/8ths of a dollar to quoting in pennies, or decimals.

Direct Market Access refers to the practice of a broker-dealer providing its client with the ability to route orders directly to a market using the broker-dealer's MPID.

ECN refers to an "electronic communications network." An ECN is an ATS that is distinguishable from a dark ATS because it provides its best-priced orders for inclusion in the consolidated quotation data. In general, ECNs offer trading services (such as displayed and undisplayed order types, maker-taker pricing, and data feeds) that are analogous to those of registered exchanges.

Exchange refers to a national securities exchange registered with the SEC. Examples include the New York Stock Exchange and NASDAQ. Exchanges are subject to greater regulatory oversight than ATSs.

Flash Orders refers to a practice whereby a trading center will for a few milliseconds show to subscribers customer buy orders priced at the national best offer, or customer sell orders priced at the national best bid. Subscribers with fast electronic connections can then execute the orders at the flash price. If the order is not immediately executed, it is withdrawn without

exposure to the entire marketplace, or is routed to other exchanges. Flash orders are only tangentially related to high frequency trading.

High Frequency Trading refers to automated trading by complex algorithms that enter and often cancel orders frequently, often thousands of times a minute. Many firms that engage in high frequency trading seek to end the day with little or no exposure to the market. Various strategies are used, including statistical arbitrage, market making and event-based strategies. In general, the term is vague and commonly has different meanings to different people.

Indication of Interest refers to an order that requires further agreement before it can be executed. There is significant debate as to the point at which an Indication of Interest, or IOI, should be treated as "actionable," *i.e.*, as a firm order, thereby requiring a facts and circumstances analysis in many cases.

Limit Order refers to an order to execute a transaction at a specified price. Marketable limit orders are buy limit orders at or above the national best offer to sell, and sell limit orders at or below the national best bid to buy. Non-marketable limit orders are buy limit orders below the national best offer, and sell limit orders above the national best bid.

Limit Up-Limit Down Plan refers to the mechanism established jointly by the national securities exchanges and FINRA that prevents trades in individual listed equity securities from occurring outside of a specified price band.

Locked and Crossed Market refers to a national best bid to buy that is at the same price as the national best offer to sell (Locked Market) or at a higher price than the national best offer to sell (Crossed Market). Exchanges are required by Regulation NMS to have rules to deter and correct locked and crossed markets. Locked and crossed markets occur when a quote is temporarily inaccessible, or when the quotes have access fees that discourage hitting the quote.

Maker-Taker Fees refers to an exchange or trading platform pricing system where rebates are given to participants that provide liquidity to the market, and fees are charged to participants that take liquidity from the market.

Naked Access refers to direct market access arrangement where the non-broker-dealer connects directly to the market without first having its orders pass through the broker-dealer's system, including its risk management controls.

Naked Short Sale refers to a short sale where the seller does not borrow or otherwise have available to deliver the shares that are sold short.

Sponsored Access usually is synonymous with **Naked Access**.

Spread refers to the difference in price between the national best bid to buy and the national best offer to sell.

Trade-through refers to the execution of an order on one market center when a more advantageous price is available at another market center, *i.e.*, "trading-through" the order. The

order protection rule of Regulation NMS, Rule 611(a)(1), requires a trading center to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, subject to numerous exceptions.

SESSION 1-D: It Takes a Village: Fund Relationships with Service Providers and Intermediaries

Rachel H. Graham, Moderator
Investment Company Institute

Keith A. Bovardi
PricewaterhouseCoopers LLP

Basil Fox
Franklin Templeton Investor Services LLC

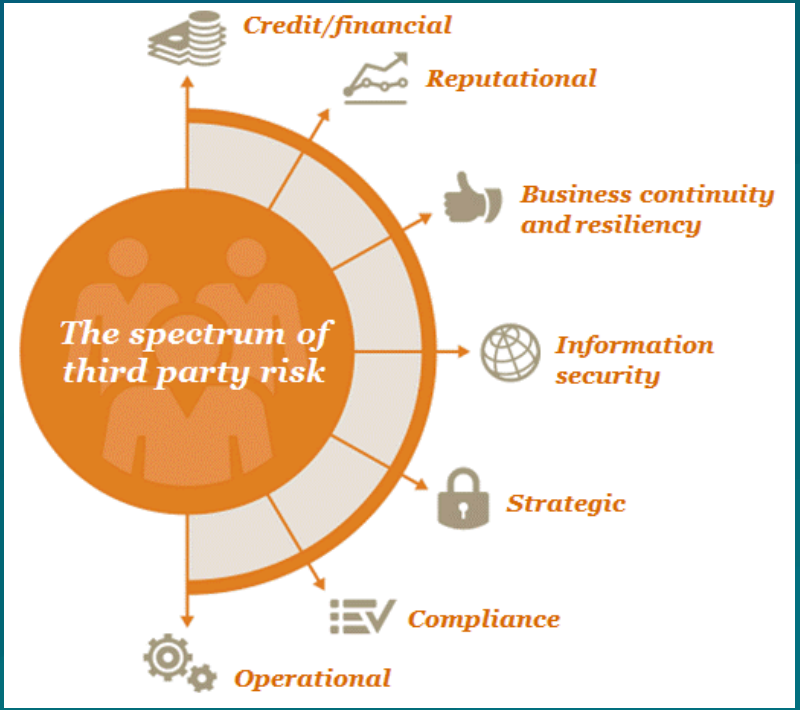
Michael F. Hogan
Charles Schwab Investment Management, Inc.

Frank J. Nasta
J.P. Morgan Asset Management

Panel Agenda

- Managing Relationships with Service Providers
- Managing Relationships with Intermediaries
- Working Together: Money Market Fund Reform Implementation
- Areas of Heightened Attention
- Weathering the Storm: How to Navigate a Business Interruption

Before We Begin…A Reminder of What is at Stake



Managing Relationships with Service Providers

- Why this is not a “one size fits all” proposition
- Initial due diligence and engagement
- Ongoing oversight and monitoring
- Potential developments on the horizon

Managing Relationships with Intermediaries

- How this differs from service provider oversight
- Using the FICCA framework and other tools
- Challenges associated with omnibus accounts

Working Together: Implementing the New Money Market Fund Reforms

- Key SEC reforms adopted in July 2014 include:
  - Floating NAV for institutional MMFs
  - Retail MMFs limited to natural persons
  - Liquidity fees and redemption gates for non-government MMFs
- Industry-wide partnership is essential for successful implementation

Working Together (cont'd)

- Involvement and coordination needed among legal and compliance, fund accounting, transfer agent, pricing services, intermediaries
- Just a few examples of the issues to be worked out:
  - For institutional funds: new process for calculating same-day multiple NAVs
  - For retail funds: how to ensure intermediary is complying with the requirement to limit beneficial ownership to natural persons?
  - How to communicate/coordinate the implementation or lifting of a liquidity fee or redemption gate

Areas of Heightened Attention

- Valuation service providers
  - SEC guidance on the use of pricing services (July 2014)
- Mutual fund distribution and sub-accounting fees
  - IM Guidance Update (Jan. 2016)
- Cybersecurity
  - OCIE examination risk alert (Sept. 2015)
  - NFA requirement for written cybersecurity program (Oct. 2015)

Weathering the Storm: How to Navigate a Business Interruption

- Importance of business continuity and contingency planning
- During the event: all hands on deck
- Post-event: evaluate the experience and determine whether any "course corrections" are needed

As We Conclude…Key Takeaways from the Panelists

1.

2.

3.

4.

fs viewpoint

www.pwc.com/fsi

Using third party service providers can be a risky business. Get fewer headaches by getting on top of the problem.

Significant others:
How financial firms can manage third party risks

pwc

Executive summary

Third parties have been the source of countless problems for financial institutions. But with the right approach to managing risk, firms can turn third parties into strategic assets.

How are financial institutions responding to demands for stronger oversight of third parties?

To find out, we surveyed financial institution leaders to better understand how their third party risk management functions operate and where they're making investments. PwC's 2014 Third Party Risk Management Survey draws on insights from executives and managers across the United States to identify key trends and leading practices in the industry.

Third parties: a growing burden

In today's environment, it would be nearly impossible to find a financial institution that doesn't contract with third parties to perform many essential functions. Over the last decade, use of third parties has indeed helped institutions to grow revenues, cut costs, and improve the customer experience.

However, these proven upsides have come with equally apparent downsides: more frequent operational setbacks such as major service interruptions, mishandling of customer or employee data, and non-compliance with laws and regulations. Many of these issues have originated with third party service providers.

The costs include not only monetary losses, but also loss of reputation and market share. Add to that the potential for regulatory enforcement actions and hefty regulatory fines, and the numbers begin to climb.

Turning liabilities into assets

Do the benefits of using third parties outweigh the downside risks, as well as the extra costs and time needed to manage and oversee them? PwC's experience and our 2014 Third Party Risk Management Survey indicate that they can—if a firm has a robust third party risk management (TPRM) program in place. Such a program can help a firm fulfil its obligations to customers, shareholders, and regulators. Ultimately, it may even make using third parties less risky than keeping those functions in-house.

45%

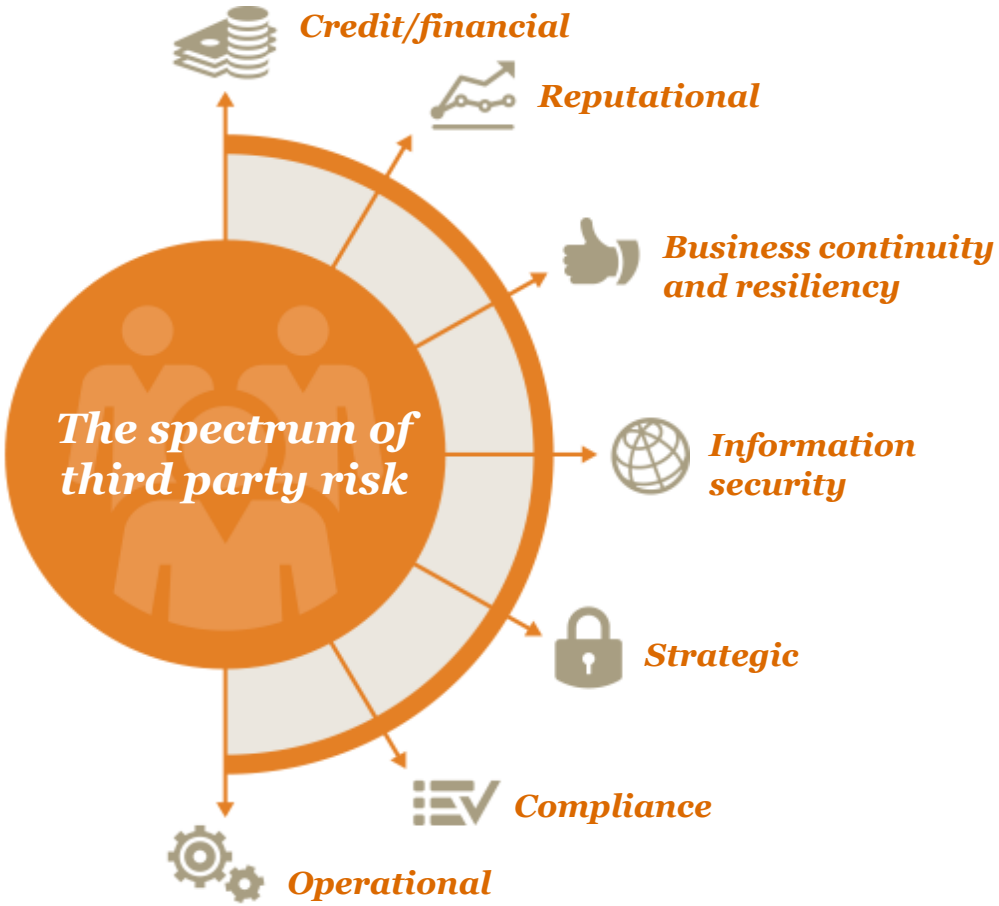
of financial services CEOs plan to enter into at least one new joint venture or strategic alliance over the next 12 months.

Source: PwC, "18th Annual Global CEO Survey," January 2015.

Point of view

The evidence is piling up: it's time for financial institutions to take a more systematic approach to managing third party risk.

Figure 1: Using third parties comes with a broad spectrum of risks.



Increased use of third parties

Over the past several years, financial institutions have increased their collaboration with third parties to perform a growing number of functions—not just printing checks, collecting payments, and processing data. This is partly in response to higher customer expectations for service.

As customers increasingly demand more customized, real-time experiences that are accessible through multiple digital channels, firms have looked to outside providers with the requisite resources and expertise. The 18th annual PwC Global CEO survey shows that more than 40% of banking CEOs see joint ventures, strategic alliances, and informal collaborations as an opportunity to strengthen innovation and gain access to new customers and new technologies.[1]

More adverse incidents

However, it is not always easy to ensure that services provided through third parties remain seamless and aligned with brand standards and strategies. As the use of third parties has grown, so have the number and severity of publicized security breaches, compliance issues, and service interruptions traceable to them. Boards of directors are increasingly worried about the number and type of activities their firms outsource and how well their firms manage the risks arising from these third party relationships (see Figure 1).

1 PwC, "18th Annual Global CEO Survey," January 2015.

Regulators have taken steps to help ensure that financial institutions keep third party risks firmly in check.

57%

of survey respondents have an accurate inventory of all third parties that handle sensitive firm, employee, and customer data.

Source: PwC, "2014 Global State of Information Security Survey," September 2014.

Stricter regulations over how financial institutions manage third party risk

Regulators are also concerned. Several US regulatory agencies have significantly raised standards for oversight of third parties in recent years.[1] Moreover, they have reiterated the range of third party relationships that the regulations cover to eliminate categorical exemptions.

These regulators particularly target business-critical functions such as payments, clearing, settlements, custody, and IT.[2] They also require that oversight and due diligence—as well as the involvement of a firm's board of directors—be commensurate with the risk and complexity of the third party relationship.

Beyond third party risk

Regulators have made it clear that financial institutions cannot outsource their controls, and that they expect firms to hold their third parties to the same high standards that firms themselves must meet.

Firms need to consider how their third parties are handling a wide range of issues:

- **Customer complaints**—The Consumer Financial Protection Bureau in the US, as well as foreign regulators such as the Financial Conduct Authority in the United Kingdom, have increased their scrutiny of the programs that firms use to address customer complaints.
- **Cybersecurity**—Regulators have cited banks, broker-dealers, investment advisers, and insurance companies for weak cybersecurity controls at their third parties. One report found that nearly one in three banks surveyed did not require their third party providers to notify them of cybersecurity breaches.[3]
- **Resiliency**—Regulators are also intent on improving the *resiliency* of financial institutions and their third parties. They want to see processes in place not only to lower the risk of failure, but to reduce the impact of a failure on the broader economy by sustaining critical operations during the resolution process.

1 These include the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board (FRB), the Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Federal Financial Institutions Examination Council (FFIEC), New York State Department of Financial Services (NYDFS), the Securities and Exchange Commission (SEC), and the Financial Industry Regulatory Authority (FINRA).

2 The OCC refers to these as "critical activities" in its OCC 2013-29 advice bulletin.

3 These include the New York State Department of Financial Services, "Report on cyber security in the banking sector," April 2015.

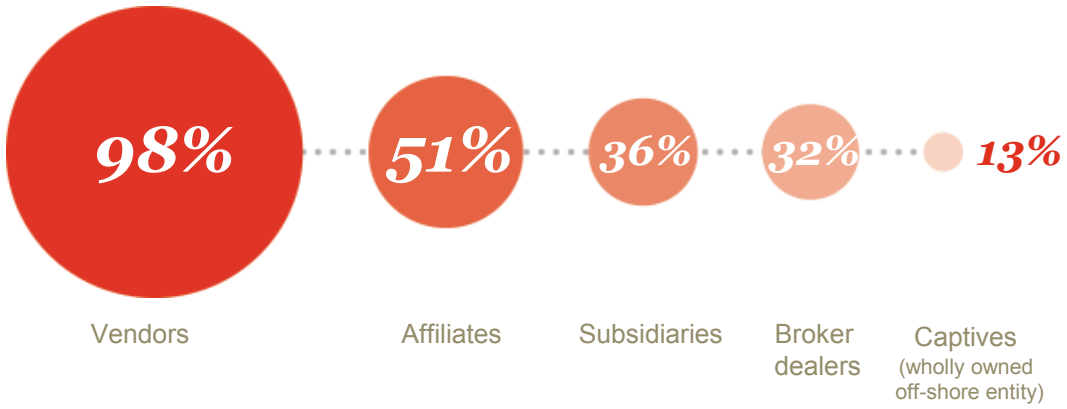
Even after years of growing reliance on third parties and increasing regulation, oversight at most financial institutions still has far too many gaps.

PwC's 2014 Third Party Risk Management Survey results show that most firms have not updated their TPRM programs to address tougher regulations.

While one of the main requirements in recently updated regulatory guidance bulletins is identifying business-critical functions, nearly two out of every five of our survey respondents have not completed this essential first step.

Figure 2: Many respondents include only vendors in their TPRM programs.

Q: What is the scope of your TPRM program?



Source: PwC, "2014 Third Party Risk Management Survey." December 2014.

Similarly, our research indicates that financial institutions are not adequately monitoring "fourth parties"—the subcontractors of their third parties. A full 45% of respondents said that they rely on third parties to monitor their subcontractors—without performing additional checks to review the results. Another 6% either don't know if their third parties use subcontractors, or have no visibility into how subcontractors are monitored.

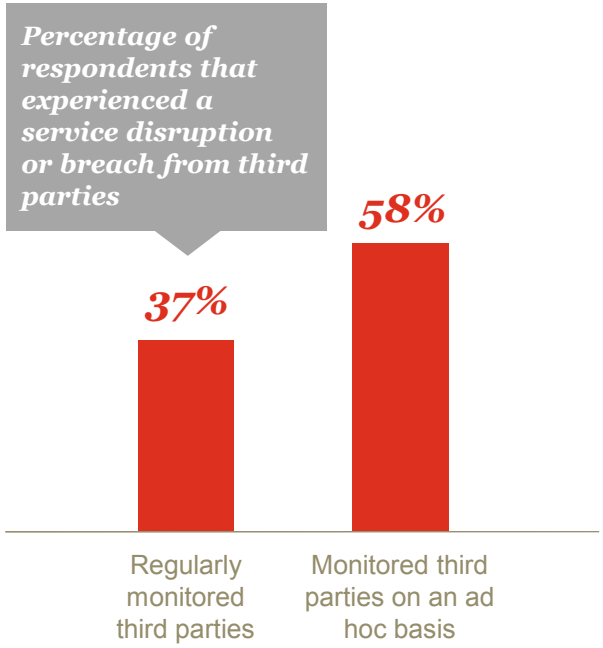
Even the scope of many TPRM programs seems problematic. In its most recent guidance bulletin, the OCC particularly highlighted its definition of third party relationships, which is "any business arrangement between a bank and another entity, by contract or otherwise."[1] As seen in Figure 2, however, barely half of our survey respondents said that their oversight programs include affiliates. New regulations relating to business continuity arising from the Dodd-Frank Wall Street Reform and Consumer Protection Act underscore the importance of having backup plans for *all* business-critical functions, not just those provided by third parties.

We also found that boards of directors are not sufficiently involved in oversight and governance of third party risk management. Only 55% of respondents said a board committee participates in TPRM oversight and governance, while some regulators explicitly expect the board to perform these functions for all third party relationships involving business-critical functions.

1 OCC, "Third Party Relationships," October 2013.

A surprising number of financial institutions are still relying on an ad hoc approach to manage their third party relationships.

Figure 3: Financial institutions that did not perform regular monitoring of third parties experienced more disruptions or breaches.



Source: PwC, "2014 Third Party Risk Management Survey." December 2014.

Our survey also showed that many firms still do not have an enterprise-wide, standardized framework for third party risk management. In some cases, these deficiencies have resulted in compliance issues, security breaches, or problems for customers.

Consider these survey findings:

- 33% of respondents that performed regular on-site visits of third parties experienced a service disruption or breach. For respondents that did not perform on-site visits or performed them only on an ad hoc basis, the percentage of disruptions rose to 50%.
- 37% of respondents that regularly monitored third parties with ongoing due diligence activities experienced a service disruption or breach. For respondents that did not perform this regular monitoring, the percentage of disruptions rose to 58% (see Figure 3).

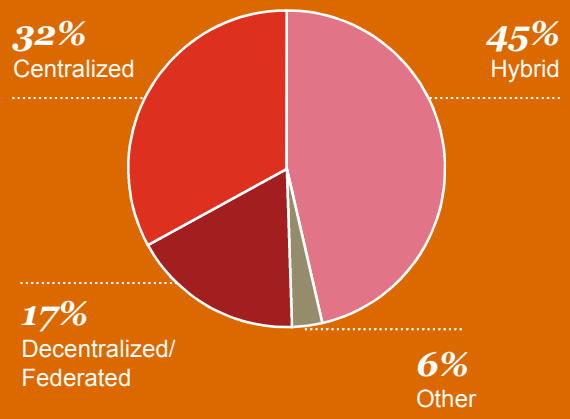
Limited reporting was another common issue that survey participants reported. Many respondents used scorecards to monitor service quality and manage issues, but did not as consistently monitor other important factors such as risks, costs, and customer complaints.

Which TPRM program structure should you adopt?

As seen in **Figure 4**, financial institutions use a variety of TPRM program structures. Culture and geography are two major factors that often influence an organization's decisions when selecting a model.

For example, a global company operating across multiple regions may find that a decentralized or hybrid model suits its purposes better than a centralized one. However, even with a decentralized model, a centralized TPRM office can help ensure that policies, procedures, and training are implemented consistently across the organization. A centralized TPRM office can also provide integrated reporting across third party relationships.

Figure 4: What model does your organization use for its TPRM program?



Source: PwC, "2014 Third Party Risk Management Survey." December 2014.

What leading practices have we seen financial services firms use to improve their TPRM practices?

While the TPRM framework will vary from firm to firm, some common elements are critical to success. These include third party stratification, insight into subcontractors, a centralized issues and complaints management database, and a centralized TPRM office to oversee the program.

Focus on the riskiest services

We consider stratification—analysis of third party relationships to identify those services requiring more extensive oversight—a particularly important first step on which other processes will depend. By focusing on the inherently riskiest relationships involving the most critical functions, firms can both control their TPRM costs and direct valuable and limited resources to where they are most needed.

Many institutions automatically assign the same risk to all services a third party performs, even though services may vary considerably for different business units and functions. We believe a firm should look at individual services a third party performs to make sure the risk assessment is in accordance with the nature and complexity of the products or services provided. This would include factors such as criticality, data sensitivity, concentration risk, and the number of business units involved.

Don't forget about subcontractors

An effective third party risk management program needs to have insight into "fourth party" subcontractors that third parties are themselves using and managing, in order to ensure that the firm understands how the subcontractors are delivering their products or services. They may find, in some cases, that there are contractual issues that keep them from fully applying their risk policies to subcontractors.

For example, a firm may not be able to insert a "right to audit" clause for fourth parties into an outsourcing agreement if the third party does not have such rights in its subcontractor relationships.

Establish a central office to administer and oversee the program

We believe that a central third party risk management office is another key ingredient in a successful TPRM program, particularly as firms expand nationally and globally. This central office should administer the oversight process, ensuring standardization and central reporting, together with a thoughtful approach to training and change management.

Leading firms are also using offshore and onshore delivery models to help standardize assessments and extend the office's reach to third parties by providing services in remote locations. They can also greatly reduce overall program costs by providing a monitoring and reporting utility service to the "three lines of defense" (business unit operations, risk management/compliance functions, internal audit).

Track TPRM issues and customer complaints in central databases

As part of the process, the TPRM office should use a central repository or database for initial due diligence, ongoing monitoring, and re-assessments. This helps maintain proper identification, management, tracking, reporting, and oversight of issues related to third parties.

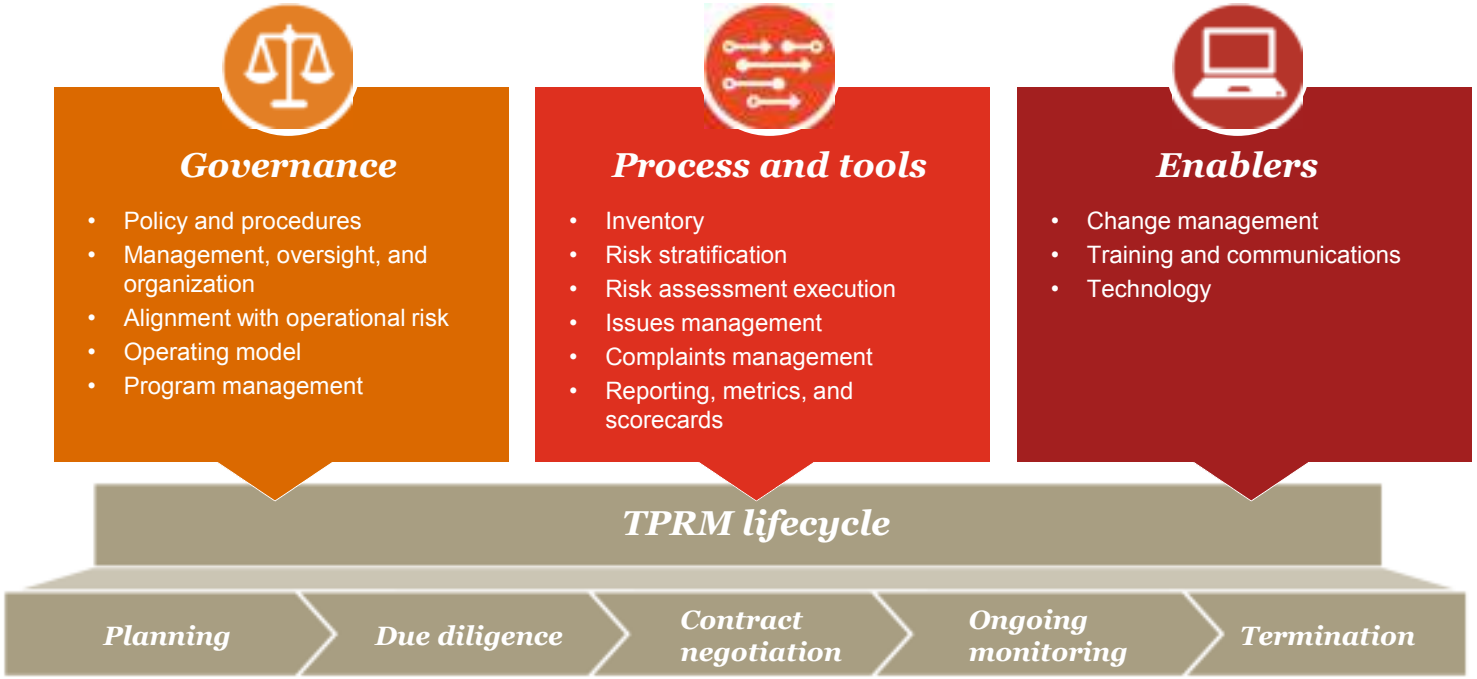
We suggest financial institutions adopt a coherent, well-thought-out third party risk management program to reduce risk exposure and help contain operational costs.

Leading practices like stratification and a central TPRM office should be part of an overarching TPRM framework. Firms should integrate this framework with their operational risk policies. We suggest that the TPRM framework incorporate three main elements: governance, processes and tools, and what we call "enablers."

Governance helps define the operating model for the TPRM program, which should include a central TPRM office as well as policies, procedures, and standards for day-to-day program management and business operations. The TPRM program applies across the entire lifecycle of each third party relationship—from the planning and due diligence phases through contract negotiation, ongoing monitoring, and termination.

A single third party inventory, risk stratification, monitoring plans, scorecards, and assessment are **processes and tools** that capture and monitor the inherent and residual risk of the services third parties provide.

To make the entire TPRM program work, we recommend that institutions adopt three essential **enablers**. The first two, change management and training and communications, promote stakeholder buy-in. An effective program also needs the right supporting technology, which can include contracting, risk assessment, and other tools that facilitate documentation and reporting.



Beyond better risk management, effective TPRM programs can also deliver valuable insights that inform strategic decisions.

Figure 5: What is the estimated value of benefits received?

Source: PwC, "2014 Third Party Risk Management Survey." December 2014.

Use TPRM to gain strategic insights

Many financial institutions are shocked when they realize how many third parties they have on their rosters. Thirty-eight percent of our survey respondents had between 1,000 and 10,000 active third party relationships, and nearly one-quarter of them had more than 10,000.

An effective TPRM program improves transparency for a firm—not only regarding how much its third parties cost, but also which business units use them and which markets and customer segments they serve. Armed with a more thorough, accurate view of the role third parties play across the organization, financial institutions can use data analytics to support strategic business decisions. The insights they gain can help to:

Improve the customer experience

More proactive monitoring and management of third party service quality can help firms improve the customer experience. It can also help reduce service disruptions and data breaches.

Identify new strategic partnerships

By analyzing how third parties are used across products, markets, and channels, firms may potentially identify new strategic partnerships that extend their sales and servicing capabilities.

Drive down costs

Our survey shows not only improved third party performance, but also clear financial results (see Figure 5). Better visibility helps firms become more strategic about which third parties they engage. They may be able to consolidate services with fewer providers, negotiate more competitive pricing, and identify less costly alternatives for low-value activities.

A TPRM program can also reduce oversight costs by focusing due diligence and monitoring efforts on the most critical and risky services, rather than using a "one-size-fits-all" approach.

Improve market agility

Regulators, including the OCC and the Fed, now require financial institutions to have a contingency plan for their most critical functions. In addition to expediting replacement of third parties if needed, these backup plans can improve a firm's ability to seize opportunities quickly—such as launching new services with existing third parties.

Enhance shareholder value

In the end, the right framework can help improve the bottom line in a number of ways, including reduction in compliance-related penalties, fewer service disruptions, less intense regulatory scrutiny, a smaller number of third parties, higher customer confidence, and more appropriately trained and placed resources.

Financial institutions can expect plenty of obstacles when building a strong TPRM program. We've identified key success factors that can help overcome these challenges.

Obstacles we've observed	Approaches for overcoming challenges
Difficulty getting business buy-in Any change can encounter resistance from stakeholders, particularly if the process is not smooth.	• Ensure visible executive sponsorship and strong leadership at a functional and program level. Make effective use of business unit leaders as "change agents" to drive adoption. • Collaborate with all functional and operating group stakeholders to improve transparency into the process. A designated liaison can help build relationships, increase awareness, and integrate third party risk management practices into day-to-day business processes. • Keep the TPRM program simple by leveraging existing processes, prioritizing the most critical TPRM objectives, automating where possible, and avoiding creation of special third party categories. This supports ease of use and encourages adoption. Once a strong foundation is in place, firms can evolve the program to support more sophisticated needs.
Defining the scope and focus of the TPRM program It is not always clear which third parties and partners a program should include, or which should take priority.	• Cast a wide net when deciding what types of third parties and relationships should be in-scope. For some financial institutions, regulatory guiding principles mandate inclusion of correspondent banks or indirect lending partners (such as auto or consumer finance companies). • Adopt third party stratification to save costs, minimize operational impact, and define where to place resources.

Financial institutions can expect plenty of obstacles when building a strong TPRM program. We've identified key success factors that can help overcome these challenges (continued).

Obstacles we've observed	Approaches for overcoming challenges
Overstretched operational resources Many financial institutions have pared costs in back office and other operations, making it difficult to monitor compliance with TPRM requirements.	• Focus on having the third parties do as much of the "heavy lifting" as possible to comply with TPRM policies. Shifting responsibility for administrative activities, such as completing questionnaires and maintaining current insurance certificates, can reduce the burden on the institution. • Use automated workflow technology and other strategic IT solutions to link third party information across functions such as procurement, accounts payable, finance, risk, and legal. IT solutions can also serve as a repository for third party documentation, route notifications and approvals, centralize tracking of issues, and enable dashboard reporting.
Inconsistent understanding of third party risks Not all parts of a financial firm will have an equal grasp of the issues involved in third party risk management. And unless they receive guidance, different departments will develop their own approaches.	• Agree upon a common set of terms and definitions; this helps create a consistent method for defining, managing, and measuring third party risks. • Focus on delivering consistent messages through both top-down and bottom-up communications (such as success stories and feedback) across business units, enterprise functions, and the board of directors. • Use multiple channels to provide information updates to program stakeholders. For example, a centralized website can host commonly requested tools and templates, while monthly newsletters can alert staff to updates.

Without a consistent and comprehensive TPRM framework, firms risk reputational damage, incomplete monitoring efforts, and increased program costs.

Operational and reputational damage

Failure to implement the right third party risk management program may hamper a financial institution in many ways. The most worrying, of course, is the potential damage that a third party's non-compliance, mishandling of sensitive information, and operational missteps can cause to a firm's customers, business, reputation, and bottom line. The consequences can include impaired customer service and loss of market share, as well as regulatory fines and penalties. Without a good TPRM program, situations like these become more likely.

Incomplete monitoring efforts

Without a comprehensive inventory of third parties and the products and services they provide, a firm may be exposed to risks it may not even be aware of—either directly through undocumented third party relationships, or indirectly through undocumented relationships that third parties may have with their subcontractors.

Unsustainable TPRM program costs

The lack of a proper framework means that a firm will probably spend more time and resources on managing third party risk than it needs to. Without processes such as stratification to identify priorities, costs may become unmanageable for an effort that is largely ineffective.

Institutions can no longer rely on an ad hoc approach to keep track of all their third party relationships and assume that all will end well.

In today's rapidly changing financial landscape, it may be hard for financial institutions to avoid using third party partners to provide ever-more sophisticated services to customers.

A robust TPRM program can help a financial institution fulfil its obligations to customers, company stakeholders, shareholders, and regulators. In the long run, we believe a strong program has the potential to drive down risks to levels equal to or lower than those for performing the functions in-house.

Competitive intelligence

Our observations of industry practices.

Current third party risk management infrastructure varies considerably among financial institutions. While some are on the forefront of leading practice, others lag behind and need to do considerable catch-up work.

Area of focus	Financial Institution A	Financial Institution B	Financial Institution C
Governance: Third party risk management framework	• The firm maintains a central third party risk management (TPRM) office, which monitors and oversees each program function and stakeholder group. • The lines of business (LoB) oversee critical third parties within each business. Risk managers have been assigned for significant relationships. • Structured groups within the LoB oversee performance of TPRM testing. • The TPRM program aligns with the operational risk program.	• The institution has LoB governance over critical third parties specific to each business. Risk managers have been assigned for significant relationships. • A central TPRM offices oversees this process with the assistance of distributed risk operation functions across the enterprise.	• TPRM program oversight is informal. The firm has limited or no governance over critical third parties, and may or may not assign third party risk managers for significant relationships.
Processes and tools: Inventory of third parties	• The firm develops a comprehensive list of third party services through data analysis of accounts payable, contract, and risk-related information. It reviews third party source systems and amends the list to reflect accurate and complete information based on data analysis and business validation. • It maintains data quality through a third party risk management system.	• The firm maintains a list of third parties that receive sensitive internal or customer information, as well as those with the largest contracts. It does not conduct any procedures to determine whether or not the list is complete.	• The firm focuses its assessments on those third parties with the largest contracts. However, it does nothing to determine whether the list is complete or that it includes smaller third parties that have access to sensitive data.
Processes and tools: Due diligence assessments	• The firm conducts and documents due diligence assessments for significant third party relationships prior to onboarding new service providers. Assessments typically include country, financial, and reputational risk, business continuity planning (BCP) and disaster recovery (DR) arrangements, information security, privacy, technology, legal, and compliance analysis.	• The firm conducts and documents due diligence assessments for significant third party relationships prior to onboarding new service providers. This assessment consistently includes financial, reputational, BCP/DR, and security analysis, but no other type of analysis.	• The firm may conduct an assessment for some new third parties (or rely on a third party self-assessment) prior to onboarding new service providers. These assessments may cover financial and security analysis.

Leading On par Lagging

Current third party risk management infrastructure varies considerably among financial institutions. While some are on the forefront of leading practice, others lag behind and need to do considerable catch-up work (continued).

Area of focus	Financial Institution A	Financial Institution B	Financial Institution C
Processes and tools: Monitoring	• The firm monitors third parties using a defined, documented, and technology-supported approach that includes monitoring plans, scorecards, assessments, and quality assurance reviews.	• The firm monitors third parties using a defined, documented, and technology-supported approach that includes performance management and ongoing due diligence assessments.	• The firm monitors third parties only on an ad hoc basis. The monitoring may be performed sporadically, but consistently includes risk management, ongoing due diligence assessments, and issues tracking.
Processes and tools: Central issues and complaints database	• The firm maintains a centralized repository for third party issues, remediation actions, assessment results, contracts, scorecards, and results from surveillance. • The firm leverages a standard approach for issues and complaints management, including escalation and exception management processes.	• The firm maintains a centralized repository for third party issues, assessment results, and contracts.	• The firm maintains several repositories in various business silos that only partially cover issues, remediation plans, assessment results, contracts, and scorecards.
Enablers: Central TPRM technology solution	• The firm has a central enterprise system that supports third party uploads; performs some automated due diligence; creates dashboards, scorecards, and other reporting; and includes two-way links to enterprise systems of record.	• The firm has a central enterprise system that performs contract management, initial due diligence and some reporting, and has a one-way link to enterprise systems of record.	• The firm has several technology solutions and systems that may cover due diligence, some reporting, and include informal manual links to enterprise systems of record.
Enablers: Third party legal and regulatory change process	• As part of its regulatory change process, the institution collaborates with its third party providers to modify activities, controls, and approaches, as needed, to remain in compliance with legal and regulatory changes.	• The firm has no system for determining whether third parties are adapting to changes in regulations.	• The firm has no system for determining whether third parties are adapting to changes in regulations.

Leading On par Lagging

A framework for response

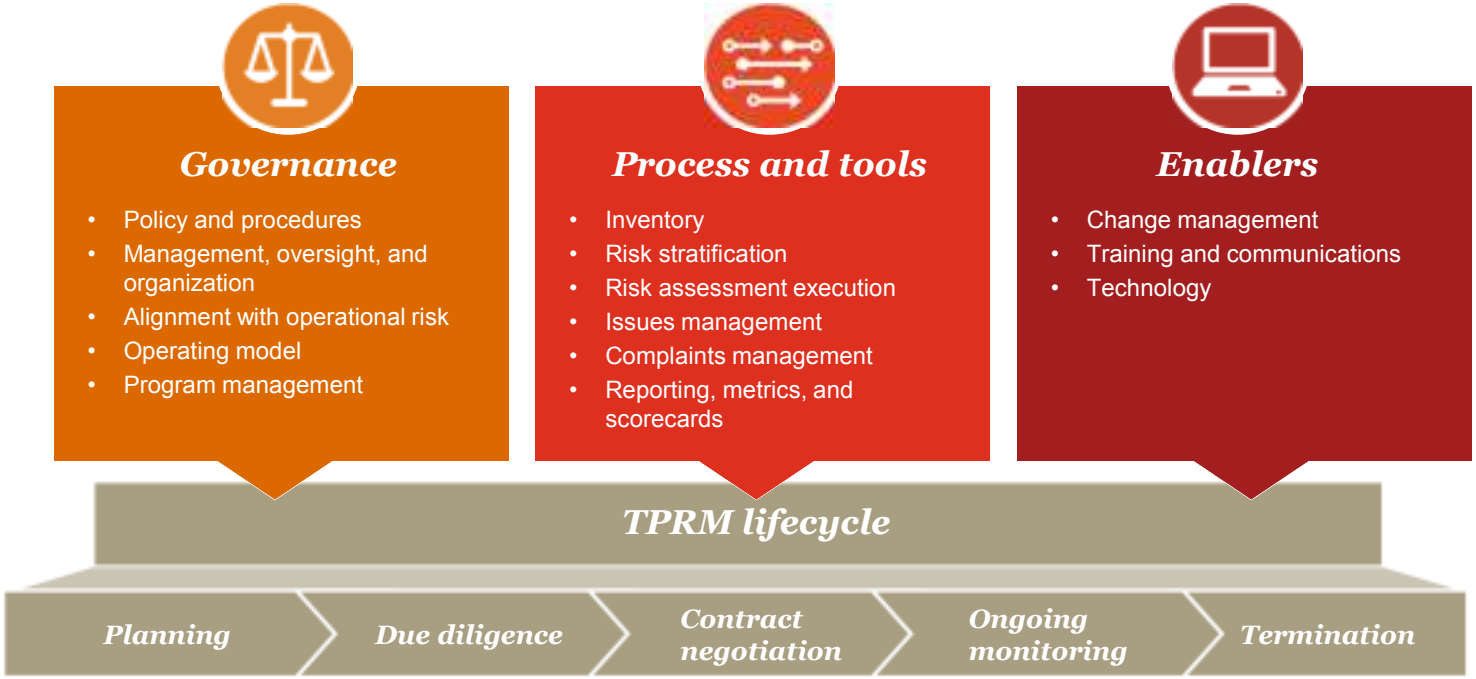
Our recommended approach to the issue.

Effective third party risk management (TPRM) requires the integration of multiple components.

We believe that to be successful, a TPRM program needs the right governance, the right processes and tools, and the right enablers in place.

- **Governance** incorporates guiding principles from senior management and regulatory guidance from federal authorities that help define a common approach to due diligence and risk management. It also assigns responsibilities for key TPRM activities.
- **Processes and tools** include the key functions that a TPRM program carries out to manage third party risk, and the mechanisms it uses to effectively perform those functions.
- **Enablers** such as technology help you run the TPRM program efficiently. Other examples such as change management, training, and communication help you gain the buy-in and support you need to meet the TPRM program's goals.

All of these components fall within the overall third party lifecycle from planning through due diligence, contract negotiation, ongoing monitoring, and termination. However, they do not have a one-to-one relationship with these phases. Governance, for example, is an important part of planning, but also part of contract negotiation and ongoing monitoring.



Governance

TPRM governance helps you provide overall direction for the program's operating model and policies and procedures for day-to-day functioning. The model should lay out program management and organization, assigning specific roles and responsibilities.

In addition, the governance approach should consider how TPRM activities integrate with your other risk management functions—particularly the three lines of defense (business units; risk, compliance and legal; internal audit)—to promote consistency and quality in program activities.

Figure 6: Illustrative governance model

Processes and tools

A successful TPRM program includes a number of processes and tools for managing and monitoring third parties throughout the five phases of each third party's lifecycle. In our experience, it's crucial for these processes and tools to include a third party inventory, risk stratification, risk assessment, issues management, reporting, metrics, and scorecards.

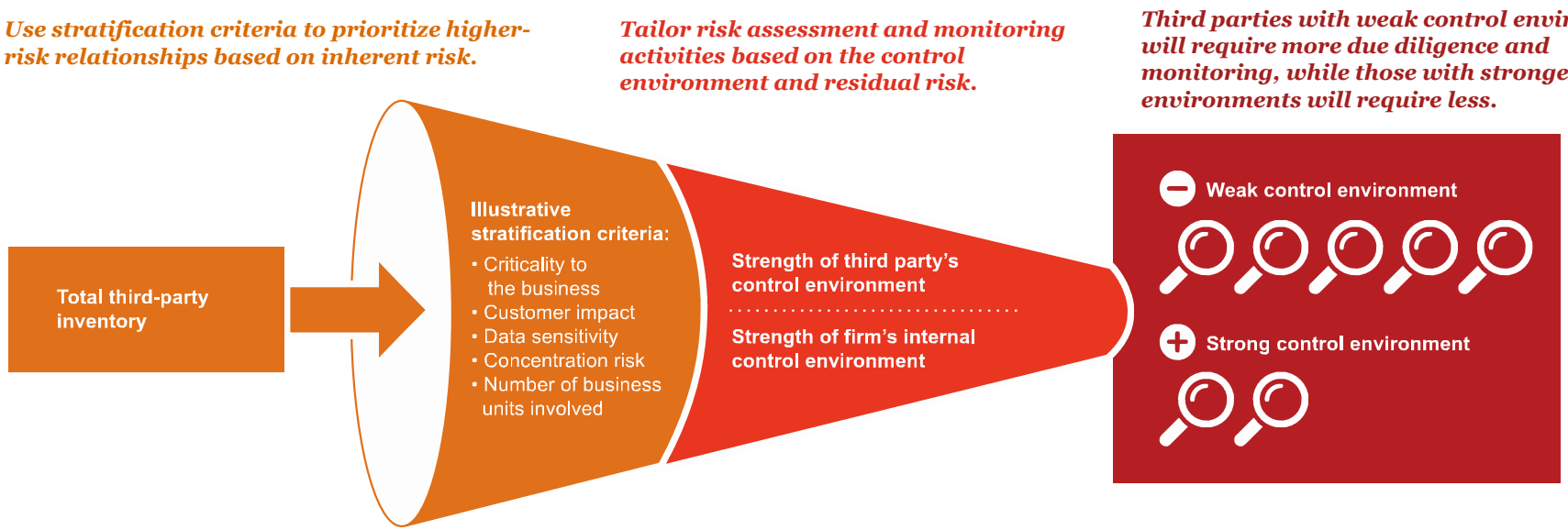
Inventory and risk stratification

Risk stratification focuses resources on the third party relationships that matter most, limiting unnecessary work for lower-risk relationships (see Figure 7). The first step is to create a thorough inventory of all third parties and the services they provide. It's important to have adequate checks and balances to verify the list is complete—for example, through periodic comparisons to the procurement and accounts payable systems.

Once the inventory has been established, filter the list based on the nature and complexity of the products or services provided, including factors such as criticality, data sensitivity, concentration risk, and the number of business units involved. Keep in mind that some third parties may provide a range of services, with varying degrees of risk, to different business units.

In addition, stratification analysis should consider concentration risk. For example, too many third parties clustered in one geographical area could intensify business continuity risk, or a firm might rely heavily on too few third parties.

Figure 7: Tailor due diligence and monitoring processes based on the levels of inherent and residual risk.



Processes and tools

Examples of third party due diligence assessments:

- Reputational
- Operational competency
- Subcontractor
- Technology
- Financial
- Business continuity and resiliency
- Country risk
- Human resource risk
- Concentration risk
- Physical security
- Information security and privacy
- Compliance

Leading financial institutions are using social listening tools, offshore delivery models, and other methods to improve the accuracy and scope of their risk assessments.

Risk assessment execution

Once a firm has identified third parties performing high-risk services, the next step is to perform due diligence assessments for each of those third parties. The results of these assessments help establish the appropriate level and frequency for monitoring and oversight for each third party.

Firms should execute risk assessments at two stages during the third party's lifecycle:

- During the due diligence process.
- Periodically after on-boarding to verify that a third party continues to meet the firm's needs.

In both of these stages, avoid using a "one-size-fits-all" approach when performing the risk assessment. Only those controls that apply to the services a third party provides require assessment.

The depth and frequency of the follow-up assessments will depend on the results of the stratification analysis. You might decide that the most inherently risky third parties will require an on-site audit twice a year, for example. Use of offshore and onshore delivery models can also standardize assessments, extend geographical reach, and reduce assessment costs.

Issues management

How an organization identifies, reports, and resolves issues is another critical component for a TPRM program. We suggest that you use a central third party issues repository with standardized processes for identifying, categorizing, remediating, and reporting issues. The repository should include issues identified not only through the TPRM program's risk assessments, but also through other sources such as internal audit and regulators.

For third parties that interact directly with customers, maintain consistent procedures for managing customer complaints. For example, third parties should have standardized protocols for identifying, classifying, escalating, and reporting customer complaints. Complaints that reach a certain severity should also be included in your customer complaint repository.

Third party relationship managers, risk managers, subject matter specialists (such as from legal or compliance), and third party representatives should collaborate to appropriately remediate all issues.

Processes and tools

Reporting, metrics, and scorecards

Reporting, scorecards and metrics—particularly key risk indicators and key performance indicators—are vital tools in managing both third party performance and the health of the TPRM program itself. Reporting should address the needs of your TPRM office, management, and business units (see Figure 8).

Third party metrics measure the performance of individual third parties in such areas as:

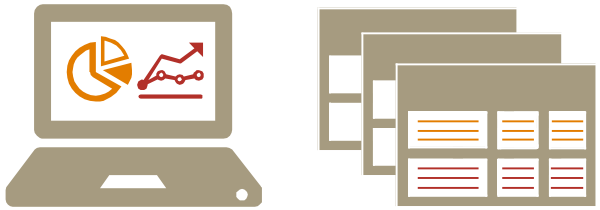
- Quality—low defects, compliance with standards.
- Customer support—effective communication, complaint management.
- Service and delivery—on-time delivery, flexibility.
- Human capital—competent staff, ongoing training.

Management-level reporting may also provide insight into how third parties are performing as a group. This aggregate reporting highlights exceptions (for example, service providers that provide similar services to others but are more costly) and trends over time (for example, whether customer complaints fall after implementation of new customer handling protocols).

TPRM program metrics measure such internal program-related progress and issues as:

- Number of third parties with access to sensitive information.
- Number of third parties supporting critical processes; percentage of critical activities performed by third parties.
- Number of issues by third party.
- Percentage of staff trained in third party risk management processes.
- Remediation plans by status.

Figure 8: Reporting should address the needs of the TPRM office, management, and business units.



Program dashboards for TPRM office

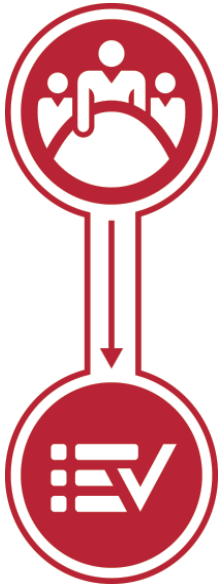
TPRM scorecards for management

Operational third party reports for business units

Enablers

As with any major undertaking, having the right support structures in place will help you implement the TPRM program and keep it current with business needs. In our view, all TPRM programs should provide for three enablers: change management, training and communications, and technology.

Figure 9: Training and communications should be linked to the broader change management program.



Change management program

- Engage stakeholders from the beginning to develop guiding principles for the TPRM program.
- Design processes to ease the transition.
- Acknowledge issues and adapt program as needed.

Training & communications

- Communicate with agents to build commitment.
- Provide training that is simple, short, and relevant.
- Build feedback loops to identify areas for improvement and share success stories.

Change management

A sound change management plan provides the right level of structure and discipline to manage the complex relationships and dependencies in a TPRM program (see Figure 9). It engages the right leaders and stakeholders from the start, soliciting their input to develop guiding principles for the TPRM program. It gives them a voice in planning the program rollout so that competing priorities can be reconciled and aligned. Lastly, it identifies the process changes and deliverables needed to foster accountability and deliver business benefits.

Training and communications

Start your TPRM training and communications program by evaluating who the stakeholders are, how they will be impacted by the TPRM program, and the level of support they will need to understand and implement new requirements. By tailoring the approach and scope of training (both materials and delivery) based on location, roles, and existing training strategy, you can improve adoption by integrating the program with day-to-day activities of employees.

Measuring training effectiveness also helps organizations find out if employees are adapting well to changes. If they're not, measurement data will give the firm valuable feedback in adapting the program.

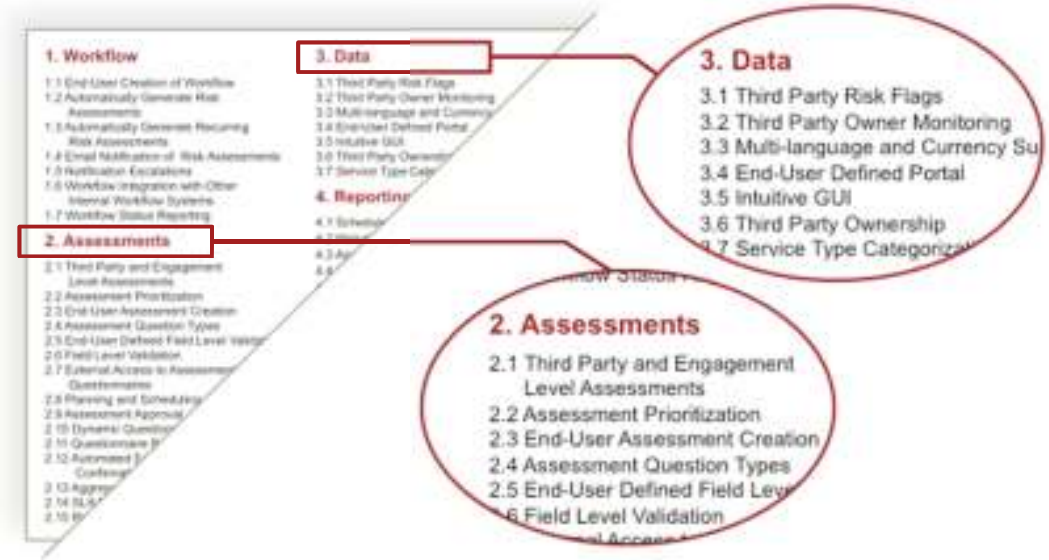
Enablers

Technology

Technology is a core enabler at every stage of a TPRM program. It is key to supporting and even completely automating workflows of all kinds, including third party risk assessments, analyzing and collating risk data, reporting, and issues management. Some programs adopt self-service portals that third parties can use for reporting, documentation, and completion of required surveys.

In general, it's important to consider your third party risk management objectives and adopt the right technology to support those objectives. When designing TPRM processes, make sure they are flexible enough to work with whatever technology platform you ultimately select.

Figure 10: Business, functional, and technical requirements should be adequately considered.



TPRM technology leading practices

- Appropriate consideration and prioritization of business, functional, and technical requirements (see Figure 10).
- Accurate and complete organizational record of third party relationships across the organization, including the employees responsible for managing them. This helps facilitate transitions as employees change roles or leave the company.
- Comprehensive contracts management system and third party master data repository.
- Consistent taxonomies for service categories and entity naming conventions between TPRM, contracting, and accounts payable systems. Interfaces between these systems help ensure that the inventory of third parties is comprehensive and up-to-date.
- Issues, complaints, and incidents repositories to track third party related items.

Appendix

Select qualifications.

PwC offers a range of services across the third party risk management life cycle tailored to clients' needs.

Sample services

Program diagnostic	We perform a high-level assessment of your firm's current TPRM function against leading practices, identifying gaps and potential needs.
Transformational roadmap	We perform an in-depth analysis, collaborating with key stakeholders to develop a new TPRM program design that fits your business and risk management goals. We also build a roadmap that identifies the key steps, anticipated level of effort, costs, and timing for getting there.
TPRM office implementation	We assist in both building and implementing a new TPRM office, including the operating model, governance and structure, policies and procedures, processes and controls, and reporting framework.
Technology enablement	We help firms assess their TPRM technology needs and identify business and technical requirements. We also support firms during the vendor selection and implementation phases, and help integrate processes into new or existing technology platforms.
Third party stratification	We help firms build a thorough inventory of their third parties and the services they provide. This includes assessing risk, determining a risk score for outsourced third parties and services, and developing a strategy to respond to that risk.
Third party assessments	Using our global network of firms and service delivery centers, we assist with on-site or remote assessment of third parties and their risk and control environments. We also help develop self-assessments for use by third parties.
Third party monitoring	Using our global network of firms and service delivery centers, we assist with on-site and remote monitoring activities (for example, data mining and analytics, monitoring external sources, and performing data aggregation and exception reporting) to support each of the three lines of defense within an organization.
Program management office (PMO)	We provide TPRM program support to firms interested in outsourcing or co-sourcing their programs. This includes, but is not limited to, project planning, execution, and reporting.

Appendix—selected qualifications

Project and client	Issues	Approach	Benefits
Integration of a new TPRM approach—Global financial services provider	This global financial services firm needed to upgrade its third party risk management program after a regulatory review identified numerous areas requiring attention. The firm also needed to better integrate its standalone TPRM program with the rest of its operational risk management infrastructure, including the information security, business continuity, legal, and contracting functions.	PwC helped the client assess its existing TPRM program and identify and design several enhancements, including: • Third party service stratification and risk ranking. • Questionnaires, standards, and training. • Issues capture, monitoring, escalation, and exception tracking tools and processes. • Service level agreements for third parties working with particular business lines. • Reporting metrics and key risk indicators, management, and oversight processes. PwC helped the client to better link the TPRM program with other operational risk assessment functions, including business continuity, information security, legal, and contracting.	The client benefited from the engagement in several respects. These benefits included: • A substantial reduction in the time and effort needed to manage a much smaller number of significant third party relationships, which decreased from more than 35,000 to less than 500. • A more thorough understanding of its third parties. • An improved methodology for identifying and monitoring high-risk third parties and services.
Creation of a third party compliance program to augment existing TPRM programs—Global financial services firm	In response to increased regulatory requirements, the client, a global financial services firm, established new standards for compliance management of third party service providers. The client needed help with: • Comparing the program with those of other large, complex banking organizations. • Implementing the newly developed process and procedures. • Developing a staffing model for managing the program. • Estimating costs for supplemental staff to perform the compliance function's third party, on-site visits.	PwC worked with the client to meet the newly established compliance standards. We helped develop appropriate guidance and procedures, and enhance existing tools to: • Identify relevant regulations based on the products or services provided by third parties. • Assess and document the third party's control environment. • Determine the appropriate nature and frequency of ongoing monitoring activities. In addition, PwC helped the client develop a staffing model by reviewing roles and responsibilities and helping to align them with standard industry practices. Finally, PwC collaborated with the client to develop a model for estimating costs for third party, on-site visits.	The client benefited from the engagement in several respects: These benefits included: • A more thorough understanding of the compliance and control environment at third party service providers. • More efficient and thorough compliance monitoring of third parties with potential cost reduction. • Improved compliance staffing model consistent with industry leading practices.

www.pwc.com/fsi

To have a deeper conversation, please contact:

Richard Altham	richard.d.altham@us.pwc.com +1 617 530 7188
TR Kane	t.kane@us.pwc.com +1 216 875 3038
Jeff Trent	jeff.s.trent@us.pwc.com + 1 646 471 7343
Darin Wettengel	darin.wettengel@us.pwc.com +1 704 350 7923
Andy Toner	andrew.toner@us.pwc.com +1 646 471 8327
Dan Morrison	daniel.morrison@us.pwc.com +1 415 498 7066
Jason Chan	jason.chan@us.pwc.com +1 214 754 5142
Garit Gemeinhardt	garit.gemeinhardt.@us.pwc.com +1 704 344 7757
Dean Spitzer	dean.v.spitzer@us.pwc.com +1 646 313 3606

"Significant others: How financial firms can manage third party risks," PwC FS Viewpoint, May 2015. www.pwc.com/fsi.

About our Financial Services practice

PwC's people come together with one purpose: to build trust in society and solve important problems.

PwC serves multinational financial institutions across banking and capital markets, insurance, asset management, hedge funds, private equity, payments, and financial technology. As a result, PwC has the extensive experience needed to advise on the portfolio of business issues that affect the industry, and we apply that knowledge to our clients' individual circumstances. We help address business issues from client impact to product design, and from go-to-market strategy to human capital, across all dimensions of the organization.

PwC US helps organizations and individuals create the value they're looking for. We're a member of the PwC network of firms in 157 countries with more than 184,000 people. We're committed to delivering quality in assurance, tax, and advisory services.

Gain customized access to our insights by downloading our thought leadership app: PwC's 365™ Advancing business thinking every day.

Follow us on Twitter @PwC_US_FinSrvcs

A publication of PwC's Financial Services Institute

Marie Carr
Principal

Cathryn Marsh
Director

Emily Dunn
Senior Manager

Kristen Grigorescu
Senior Manager

HOME

SESSION 2-A: Across the Board: A Discussion of Hot Topics Affecting Fund Boards

Amy B. R. Lancellotta, Moderator
Independent Directors Council

Darrell N. Braman
T. Rowe Price Associates, Inc.

Woodrow W. Campbell
Debevoise & Plimpton LLP

Margery K. Neale
Willkie Farr & Gallagher LLP

Evolution of Board Responsibilities

- What is the appropriate role of fund boards?
  - Mutual fund directors vs. corporate directors
  - Oversight of potential conflicts of interest
  - Oversight, not management
- Changes in regulatory requirements; changes in SEC attitude
  - 1940 Act – 4 specific responsibilities; state law fiduciary duties
  - Exemptive rules rely on board oversight, boards can rely on summary reports
  - Rule 17f-5, recognition that board approval of foreign sub-custodians does not make sense
  - Rule 38a-1, the fund compliance rule: did the SEC get it right?

Evolution of Board Responsibilities (cont'd)

- Fast forward to the financial crisis: heightened focus on overseeing risk management introduces new challenges for boards
  - Today's regulatory issues
    - Liquidity risk management
    - Derivatives
- Changes in board responsibilities have broad consequences
  - Board recruitment and training
  - Use of committees
  - Educating boards; meeting agendas and materials
  - Other considerations

Oversight of Financial Intermediaries and Fund Service Providers

- Distribution payments and sub-accounting fees
  - Staff Guidance Update (2016)
  - What are boards doing today?
- Oversight of cybersecurity
  - Funds sponsored by asset management firms vs. insurance company and banks
  - Service providers; internal vs. external transfer agent
  - Distribution channels; directly vs. indirectly distributed

Hallmarks of a Well-Functioning Board

- The more things change, the more they stay the same. A well-functioning board should have:
  - Excellent leadership
  - Effective committee structure
  - Collegiality
  - Diligent and responsive counsel

Resources

- IDC/ICI Overview of Fund Governance Practices, 1994-2014
- ABA Fund Director's Guidebook, Fourth Edition
- Memo on SEC Staff Guidance on Mutual Fund Distribution and Sub-Accounting Fees, Margery K. Neale and Dianne E. O'Donnell, Willkie Farr & Gallagher LLP (available online)
- SEC Staff Letter to IDC and MFDF, Nov. 2, 2010, allowing boards to rely on quarterly summary reports in approving transactions under certain exemptive rules (available online)

SESSION 2-A: Across the Board: A Discussion of Hot Topics Affecting Fund Boards

Amy B. R. Lancellotta, Moderator
Independent Directors Council

Darrell N. Braman
T. Rowe Price Associates, Inc.

Woodrow W. Campbell
Debevoise & Plimpton LLP

Margery K. Neale
Willkie Farr & Gallagher LLP

Evolution of Board Responsibilities

- What is the appropriate role of fund boards?
  - Mutual fund directors vs. corporate directors
  - Oversight of potential conflicts of interest
  - Oversight, not management
- Changes in regulatory requirements; changes in SEC attitude
  - 1940 Act – 4 specific responsibilities; state law fiduciary duties
  - Exemptive rules rely on board oversight, boards can rely on summary reports
  - Rule 17f-5, recognition that board approval of foreign sub-custodians does not make sense
  - Rule 38a-1, the fund compliance rule: did the SEC get it right?

Evolution of Board Responsibilities (cont'd)

- Fast forward to the financial crisis: heightened focus on overseeing risk management introduces new challenges for boards
  - Today's regulatory issues
    - Liquidity risk management
    - Derivatives
- Changes in board responsibilities have broad consequences
  - Board recruitment and training
  - Use of committees
  - Educating boards; meeting agendas and materials
  - Other considerations

Oversight of Financial Intermediaries and Fund Service Providers

- Distribution payments and sub-accounting fees
  - Staff Guidance Update (2016)
  - What are boards doing today?
- Oversight of cybersecurity
  - Funds sponsored by asset management firms vs. insurance company and banks
  - Service providers; internal vs. external transfer agent
  - Distribution channels; directly vs. indirectly distributed

Hallmarks of a Well-Functioning Board

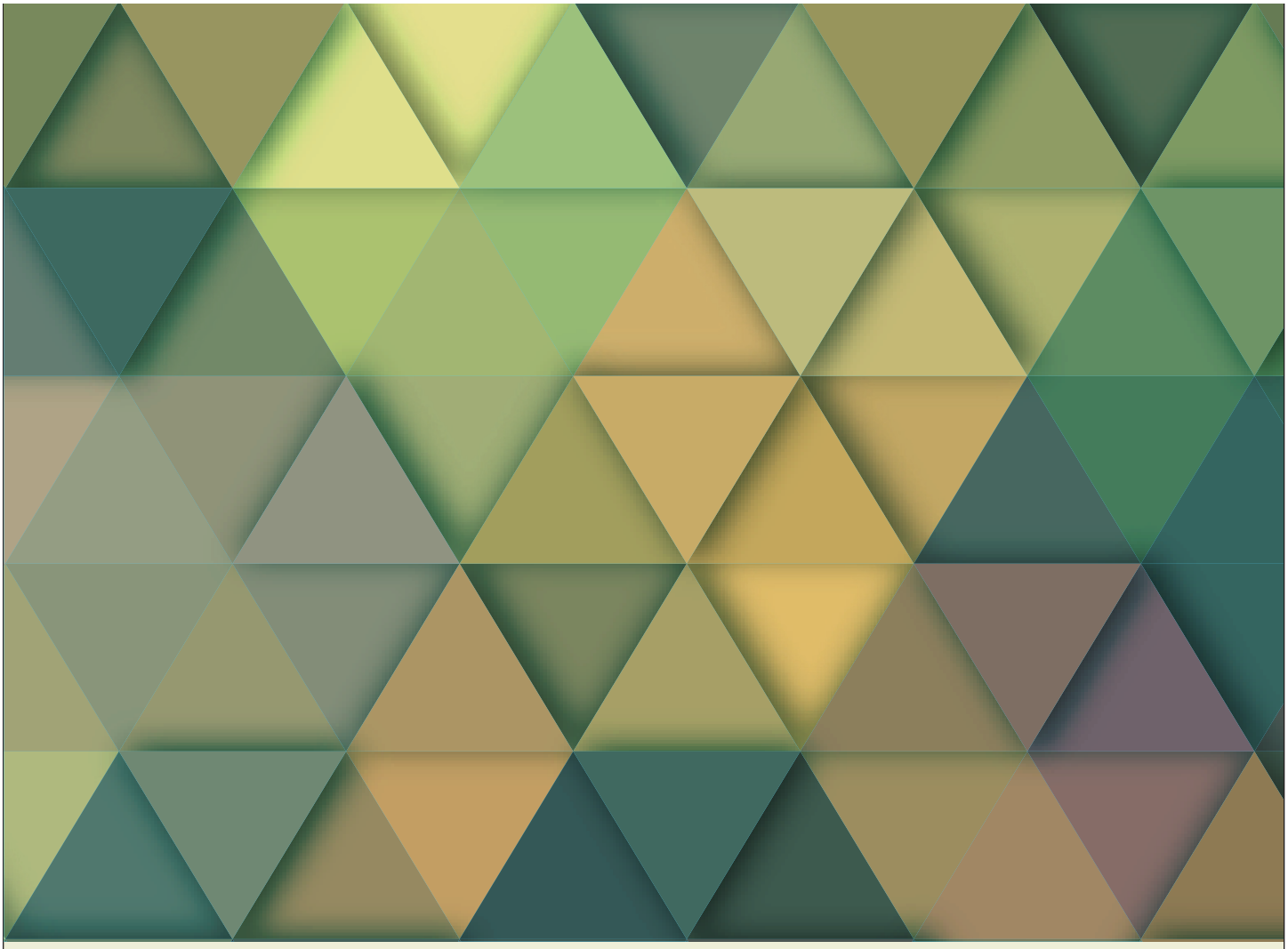
- The more things change, the more they stay the same. A well-functioning board should have:
  - Excellent leadership
  - Effective committee structure
  - Collegiality
  - Diligent and responsive counsel

Resources

- IDC/ICI Overview of Fund Governance Practices, 1994-2014
- ABA Fund Director's Guidebook, Fourth Edition
- Memo on SEC Staff Guidance on Mutual Fund Distribution and Sub-Accounting Fees, Margery K. Neale and Dianne E. O'Donnell, Willkie Farr & Gallagher LLP (available online)
- SEC Staff Letter to IDC and MFDF, Nov. 2, 2010, allowing boards to rely on quarterly summary reports in approving transactions under certain exemptive rules (available online)

OVERVIEW OF

Fund Governance Practices, 1994–2014



IDC
INDEPENDENT DIRECTORS COUNCIL
Committed to Strong Fund Governance

ICI
INVESTMENT COMPANY INSTITUTE®

Overview of Fund Governance Practices, 1994–2014

Key Findings

» Fund boards, as a group, follow strong governance practices to best serve the interests of shareholders. Studies of board practices indicate that over the past 20 years, fund boards have adopted such practices in advance of, or in the absence of, any regulatory mandate to do so.

» Independent directors make up three-quarters of boards in 83 percent of fund complexes. Between 1996 and 2014, the number of complexes reporting that independent directors hold 75 percent or more of board seats rose from 46 percent to 83 percent. Current SEC rules require only that funds relying on common exemptive rules have boards with a majority of independent directors.

» Nearly two-thirds of fund complexes report having an independent board chair. Sixty-five percent of complexes reported having boards with independent chairs at year-end 2014. When complexes that have boards with independent lead directors also are considered, 89 percent of participating complexes report having an independent director in board leadership at year-end 2014.

» More than nine in 10 fund complexes report that separate legal counsel serve their independent directors. The total percentage of complexes reporting that independent directors are represented either by dedicated counsel or counsel separate from the adviser's has increased over the past decade, from 64 percent in 1998 to 92 percent at year-end 2014. More than half of complexes say their independent directors retain their own counsel—separate from both fund counsel and the adviser's counsel.

» Substantially all fund complexes have an audit committee financial expert. Though current rules require only that funds disclose whether the audit committee includes a financial expert, 97 percent of participating complexes report having at least one financial expert on the audit committee.

Background

Fund boards perform an important role in the oversight of the fund industry. The Investment Company Act of 1940 (1940 Act) and its related rules impose significant responsibilities on fund boards and dictate elements of board structures and practices. Fund governance practices have evolved, and in 1995, the Investment Company Institute (ICI) began to document those practices by collecting data from fund complexes biennially.[1] The Independent Directors Council (IDC) was formed in 2004, and since then, the studies have been conducted jointly by ICI and IDC.

Board practices have been influenced by changing attitudes toward governance and by regulatory actions (see "Fund Governance Developments" below). In 1999, for example, a panel of interested and independent fund directors convened by ICI identified 15 practices to enhance the independence and effectiveness of fund directors. Their recommendations were published as the *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (*Best Practices Report*).[2] Studies since 1999 document the effect of the *Best Practices Report* and other developments on board practices industrywide. IDC has issued a number of white papers, each of which provides practical guidance to boards. The papers are listed in the back of this overview.

This overview provides common fund governance practices covering the period from 1994 through 2014, and is an update to the overview published two years ago.[3] Though the complexes participating in each biennial study have varied over the years—and some fluctuations in the data may be attributable to those variances—an examination of the data reveals certain trends. To put these data in context, this overview includes information on fund assets managed by complexes that participated in each of the biennial studies, the average fund assets served per director, the average number of funds served, and selected independent director characteristics.

Fund Governance Developments

1999	SEC hosts roundtable discussion on fund governance.
1999	ICI publishes advisory group report on best practices for fund directors (*Best Practices Report*).
2001	SEC adopts rule amendments focused on board governance requirements (2001 SEC Rules).[4]
2004	SEC adopts rule amendments focused on board governance, including requirements that fund boards be composed of at least 75 percent independent directors and chaired by an independent director (2004 SEC Rules).[5]
2006	Federal appeals court invalidates requirements in the 2004 SEC Rules that fund boards be composed of at least 75 percent independent directors and chaired by an independent director.[6]
2006	SEC seeks additional comment on 75 percent independent director composition and independent chair requirements.[7]

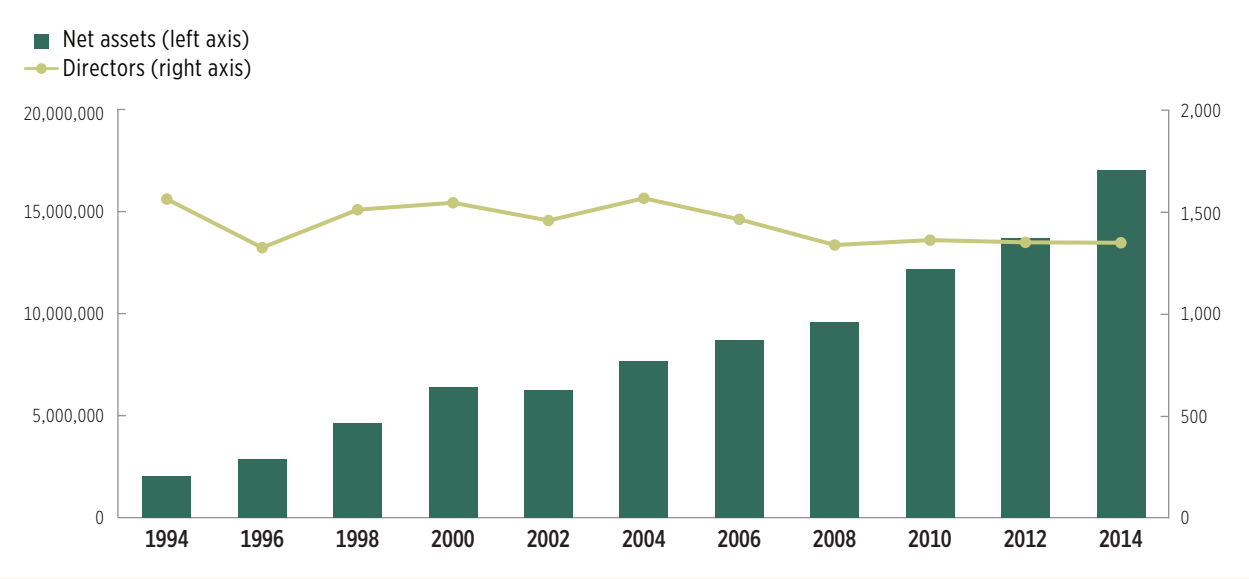
Fund Net Assets and Independent Directors at Participating Complexes

To put the analysis in context, this overview presents data on the aggregate fund net assets of complexes participating in each of the biennial studies. Further, this overview presents the aggregate number of independent directors at these complexes. It should be noted that the number and identity of complexes participating in the studies change over time (Figure 1).

FIGURE 1

Total Net Assets and Total Independent Directors at Participating Complexes

Millions of dollars, 1994–2014



Fund Net Assets and Funds Served by Independent Directors

Both fund net assets served by independent directors and the average number of funds served have increased in each of the studies conducted over the 20-year period (Figures 2 and 3).

FIGURE 2

Net Assets Served by Independent Directors

Millions of dollars, 1994–2014

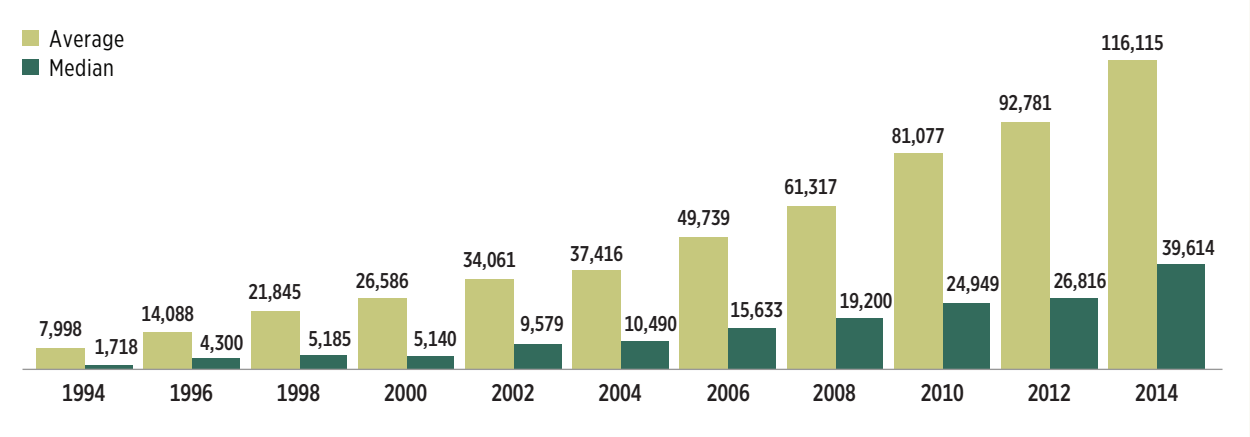
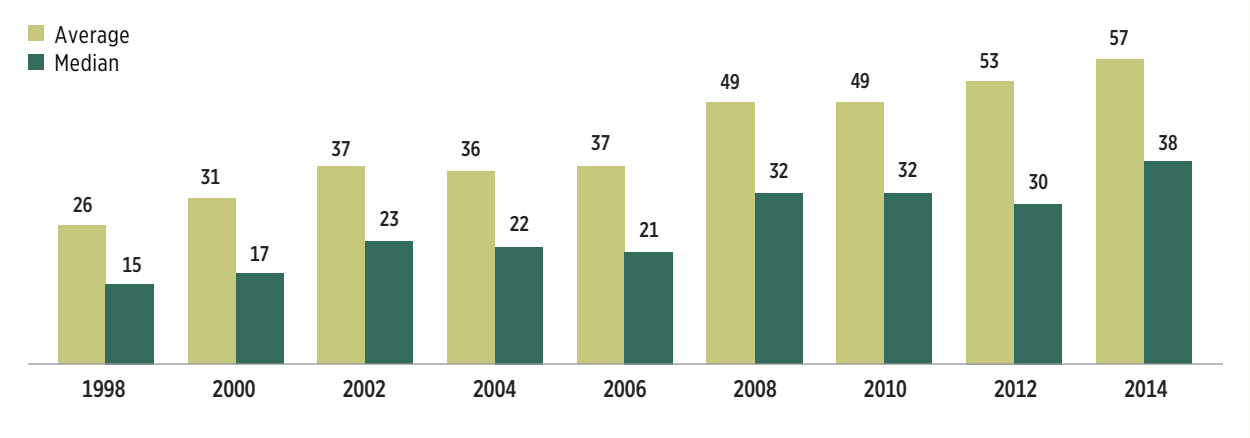


FIGURE 3

Funds Served by Independent Directors

Number of funds, 1998–2014



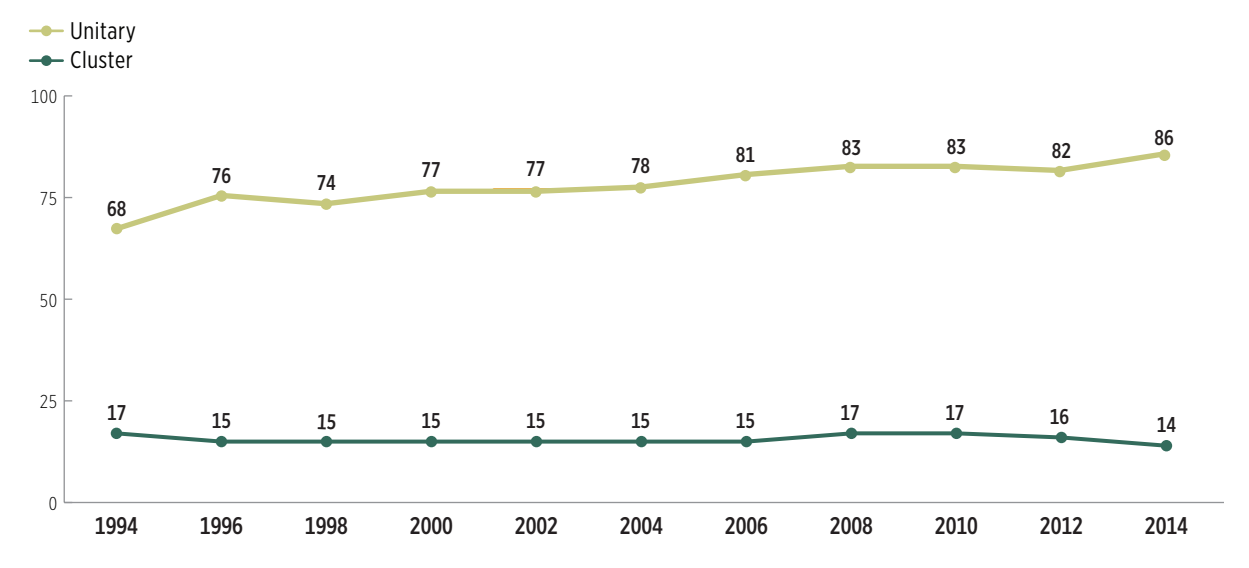
Board Structure: Unitary or Cluster Boards

Since 1994, most complexes have employed a unitary board structure, meaning that a single board oversees all funds in the complex. As of 2014, 86 percent of participating complexes have a unitary board structure (Figure 4). Some complexes, particularly large ones, have adopted a cluster structure, where there are several boards within the complex, each overseeing a designated group of funds. The number and makeup of the clusters may be determined by several factors, including the type of funds (e.g., money market, institutional) or whether the funds in a particular cluster were acquired by the complex as a group. The percentage of participating fund complexes using the cluster structure over the last 20 years has remained relatively stable at around 14 to 17 percent (Figure 4).

FIGURE 4

Board Structure

Percentage of fund complexes, 1994–2014



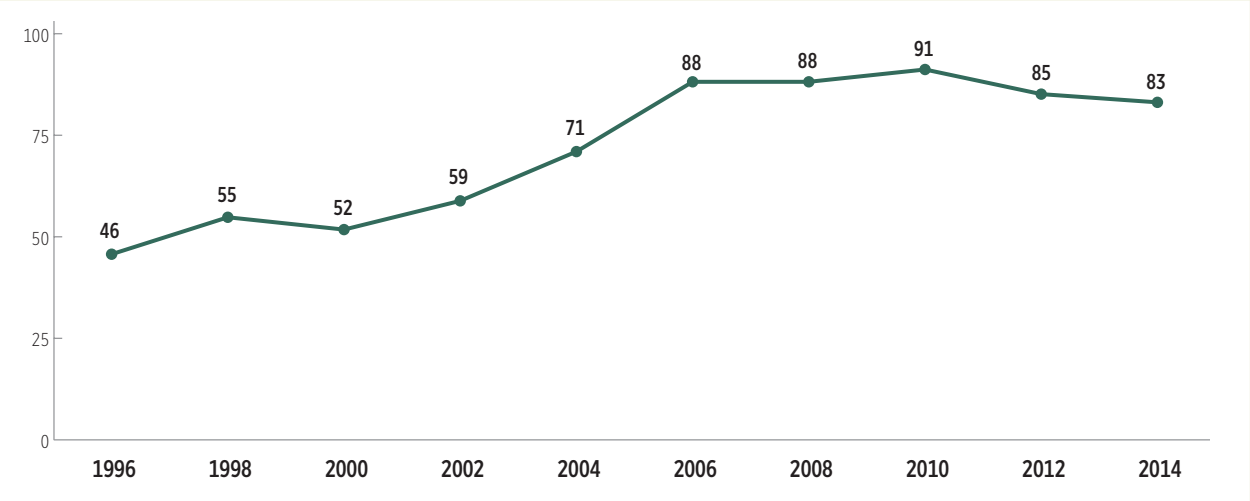
Complexes in Which 75 Percent or More of Board Seats Are Held by Independent Directors

Over the years, these studies have collected information on the number of independent directors relative to the total number of directors at a fund complex. Under the 1940 Act, independent directors—directors who are not "interested persons" of the fund under the Act—must constitute at least 40 percent of each board unless special circumstances (e.g., following a merger) dictate a higher percentage. ICI's *Best Practices Report* recommends that each board have a two-thirds majority of independent directors. The 2001 SEC Rules mandated a majority of independent directors for funds relying on certain exemptive rules, and the 2004 SEC Rules increased the required percentage to 75 percent independent directors on each board.[8] In 2006, a federal appeals court invalidated the 75 percent independent director requirement.[9] The SEC subsequently sought additional comment on that component of the fund governance rules, but has not taken further action. In 2004, the number of complexes with 75 percent of board seats held by independent directors increased to 71 percent, likely in response to the 75 percent mandate that was pending at that time. By 2006, the vast majority (88 percent) of complexes reported that 75 percent or more of the board seats at the complex were held by independent directors. In recent years, the number of complexes with a board composition of at least 75 percent independent directors has remained relatively stable (Figure 5).

FIGURE 5

Complexes Where 75 Percent or More of Board Seats Are Held by Independent Directors

Percentage of complexes, 1996–2014



Number of Independent Directors per Complex and per Board

The number of independent directors in a given complex is influenced by the total number of directors on the board and the number of fund boards at the complex. The average number of independent directors per complex has remained unchanged over the course of the 20-year period (Figure 6). The median number has remained relatively stable over the same period. In 2008, the study began reporting the number of independent directors per board (in addition to the number per complex). Since that time, the median and average number of independent directors per board generally has been six (Figure 7). The study will continue to report the number of independent directors per board going forward.

FIGURE 6

Independent Directors per Complex

1994–2014

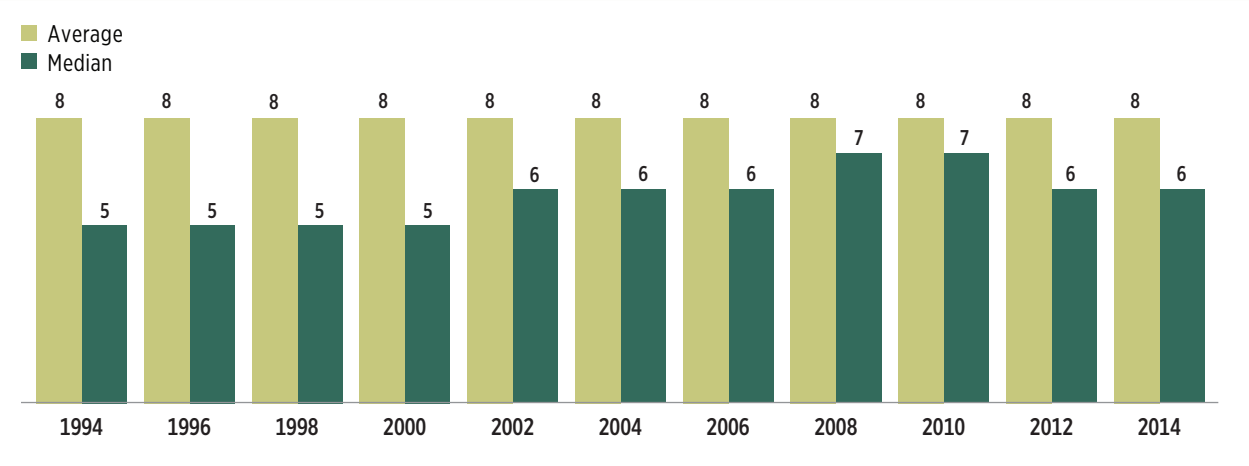
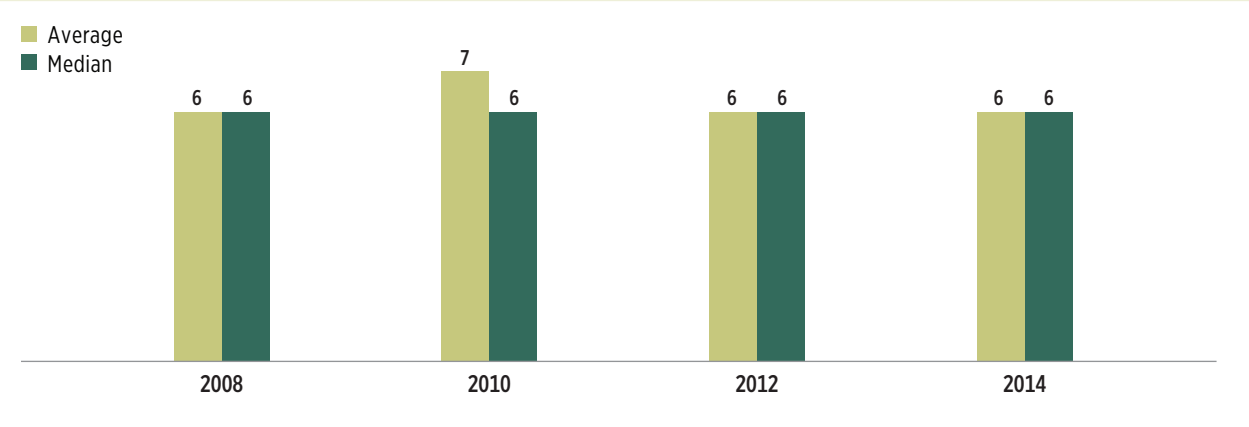


FIGURE 7

Independent Directors per Board

2008–2014



Frequency of Board Meetings

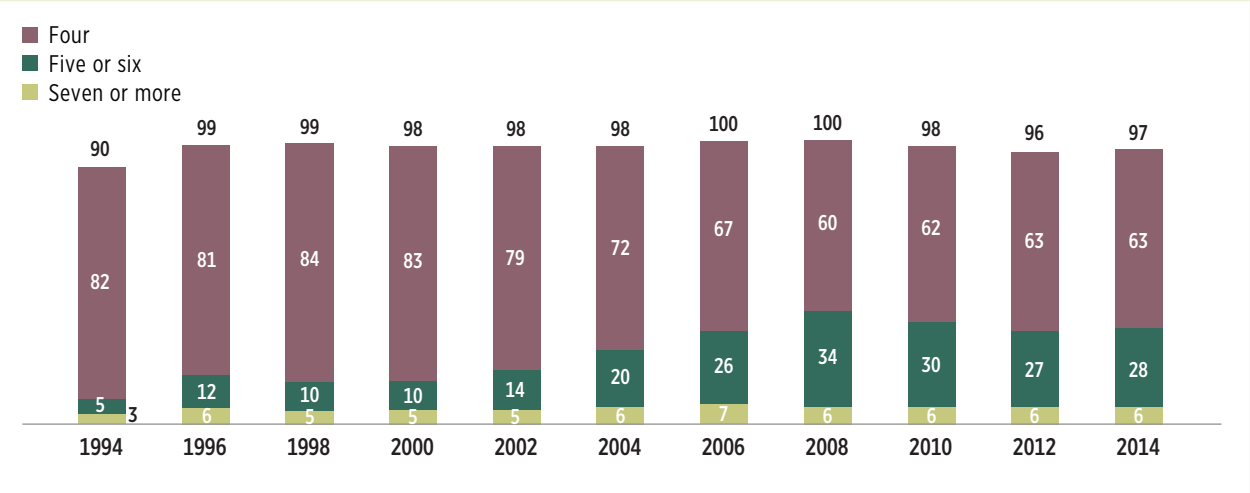
The frequency of regularly scheduled board meetings is not dictated by statute or rule. Approval of the advisory contract, among other duties, must occur annually at an in-person meeting, but the timing, length, and nature (e.g., in person, telephonic) of the other meetings are matters to be determined by each board.[10] The decision on the frequency of meetings may be influenced by several factors, including the size of the board and the number of funds the board oversees. A board also may elect to meet less frequently but for more days each time. One-third of participating complexes indicate that they held five or more regularly scheduled in-person board meetings in 2014 (Figure 8).

In actuality, fund directors often meet more frequently than called for by their regular schedule. Additional in-person or telephonic meetings are held, if necessary, to address specific issues.

FIGURE 8

Regularly Scheduled In-Person Board Meetings per Year

Percentage of complexes, 1994–2014



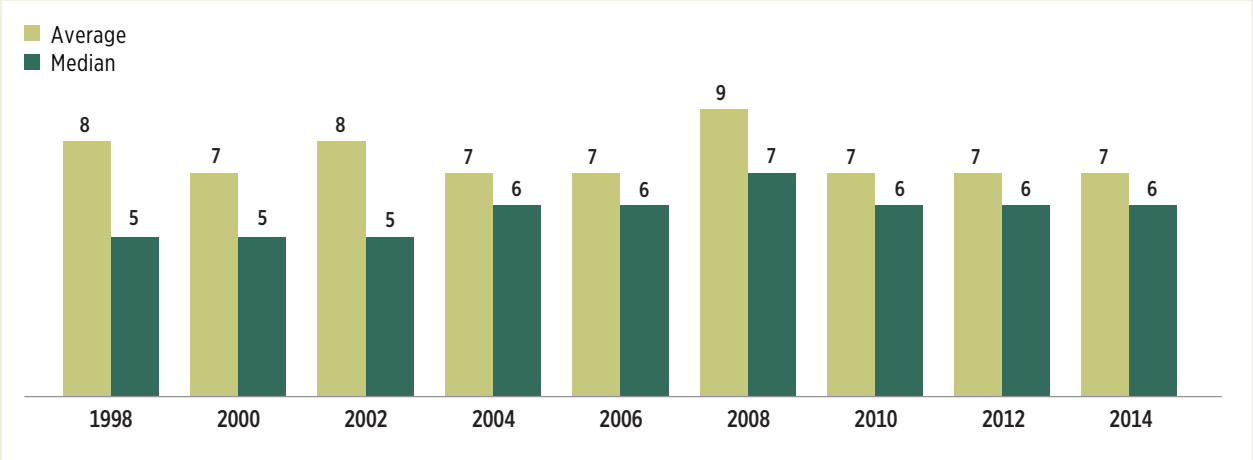
Board Meetings and Committee Meetings in Which Independent Directors Participated

As noted, a board's regularly scheduled meetings may be augmented by nonscheduled or impromptu meetings. For that reason, since 1998, the studies have included information on the number of board meetings in which independent directors actually participated, either by phone or in person. Between 1998 and 2006, the number of board meetings averaged between seven and eight per year, increased to nine in 2008, and subsequently returned to seven per year (Figure 9). The turbulent market environment in late 2008 may have prompted an increase in the number of impromptu board meetings in 2008. Additionally, some independent directors serving at cluster complexes may serve on more than one board. Such directors would normally attend four or more board meetings for each cluster they serve, and this practice likely would increase the reported average number of board meetings in which independent directors participated.

FIGURE 9

Board Meetings in Which Independent Directors Participated

1998–2014



Quite often, committee meetings are held in conjunction with regularly scheduled board meetings. If necessary to accomplish their respective missions, committees may hold additional meetings. In addition, independent directors may serve on multiple committees. Since 1998, the average number of committee meetings in which independent directors participated has increased steadily from five to 10 (Figure 10).

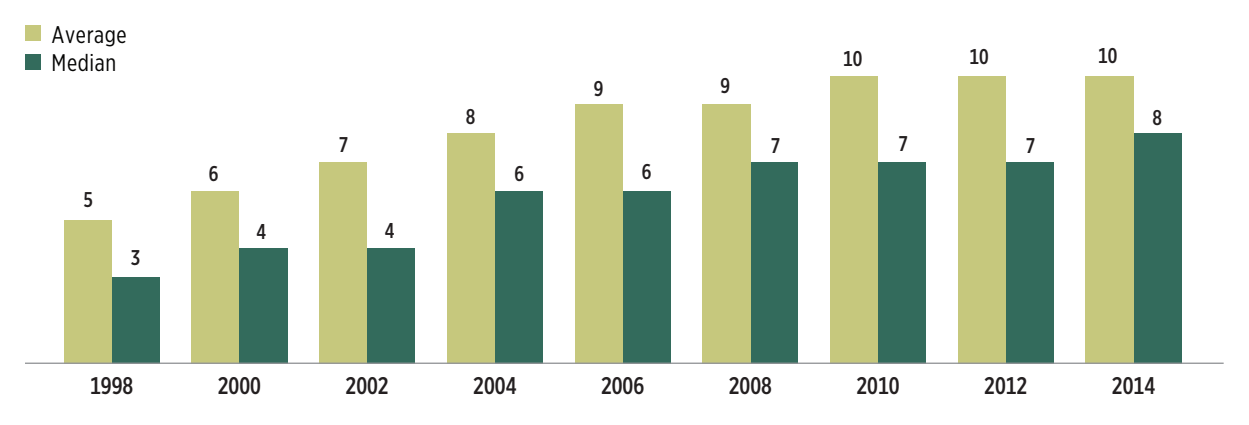
Independent Board Chair or Lead Director

Board practices relating to independent directors serving as the board chair vary greatly. Prior to the repeal of the Glass-Steagall Act in 1999, independent board chairs were required for bank-sponsored funds. Some nonbank-sponsored funds adopted the practice, but it was not widespread. Although no longer mandated after the enactment of the Gramm-Leach-Bliley Act in 1999, the independent chair practice was retained by most bank-sponsored funds. Other boards designated an independent director to serve as the primary liaison between independent directors and the adviser. This practice of designating an independent "lead director" was identified in ICI's *Best Practices Report* as an effective governance tool. The 2004 SEC Rules mandated an independent chair for all boards, but that requirement was invalidated by a federal appeals court.[11] In 2006, the SEC sought additional comment on that component of the fund governance rules, but has not taken further action.

FIGURE 10

Committee Meetings in Which Independent Directors Participated

1998–2014

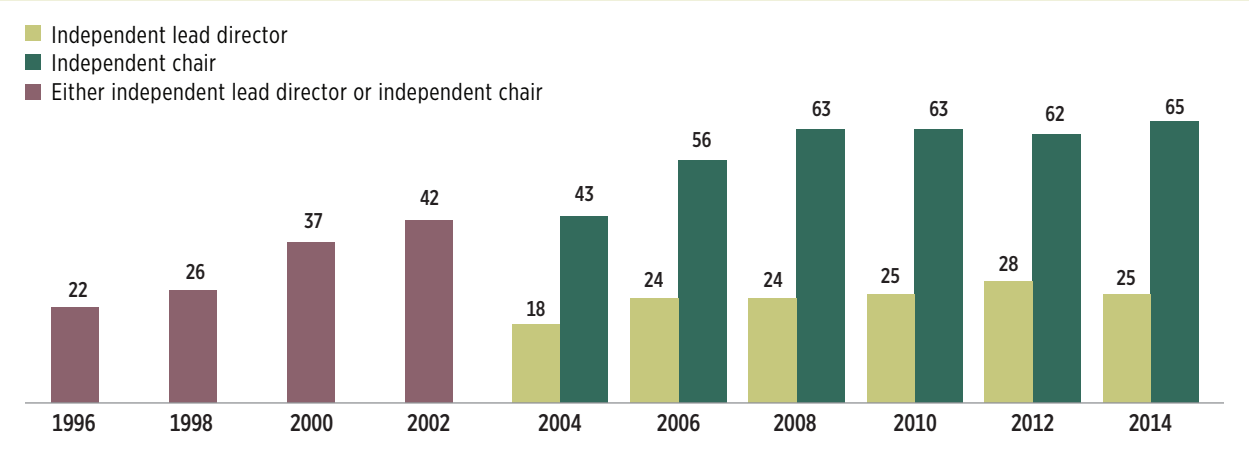


Beginning in 1996, survey participants were asked if they had either an independent board chair or an independent lead director, but they were not asked to distinguish between the two. The 2004 study, for the first time in the series, collected data separately on the incidence of independent board chairs and independent lead directors. The adoption of the 2004 SEC Rules and the board deliberations surrounding it resulted in a marked increase that year in the number of boards with independent board chairs. In 2014, nearly two-thirds (65 percent) of the participating complexes reported that they have an independent board chair. As of year-end 2014, 89 percent of participating complexes reported having an independent board chair or an independent lead director (Figure 11).[12]

FIGURE 11

Complexes with an Independent Board Chair or Independent Lead Director

Percentage of complexes, 1996–2014



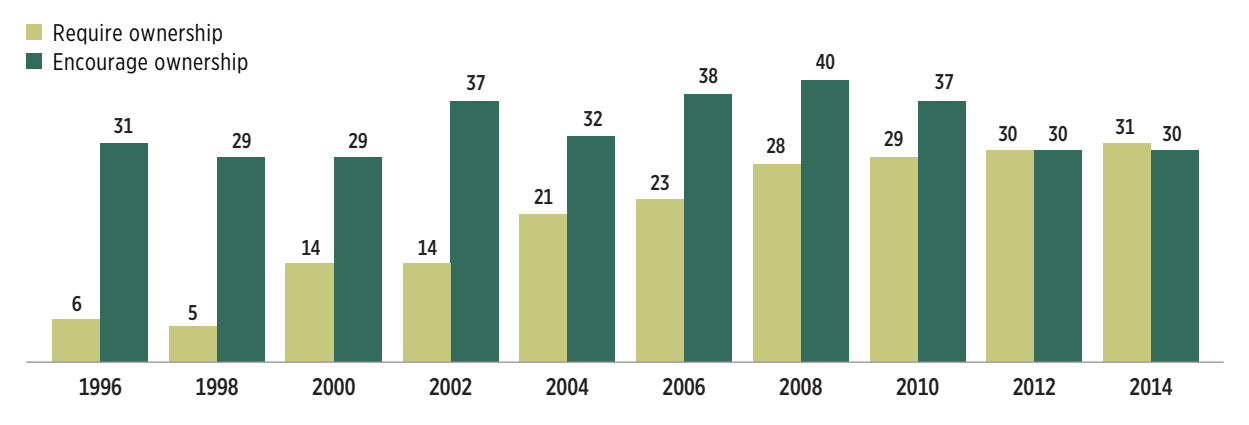
Independent Director Fund Share Ownership

Though many independent directors choose to own shares of the funds they oversee, the practice is not routinely required. This issue attracts some attention because SEC rules require disclosure of fund share ownership by directors. The data indicate that the number of complexes formally requiring fund share ownership by independent directors has increased steadily since 1996 (Figure 12). As of year- end 2014, 31 percent of participating complexes reported that they have a formal policy requiring such fund share ownership. The segment of complexes encouraging, as opposed to requiring, ownership of fund shares was 30 percent in 2014. ICI's *Best Practices Report* recommends that directors invest in the funds of the boards on which they serve.

FIGURE 12

Share Ownership by Independent Directors

Percentage of complexes, 1996–2014



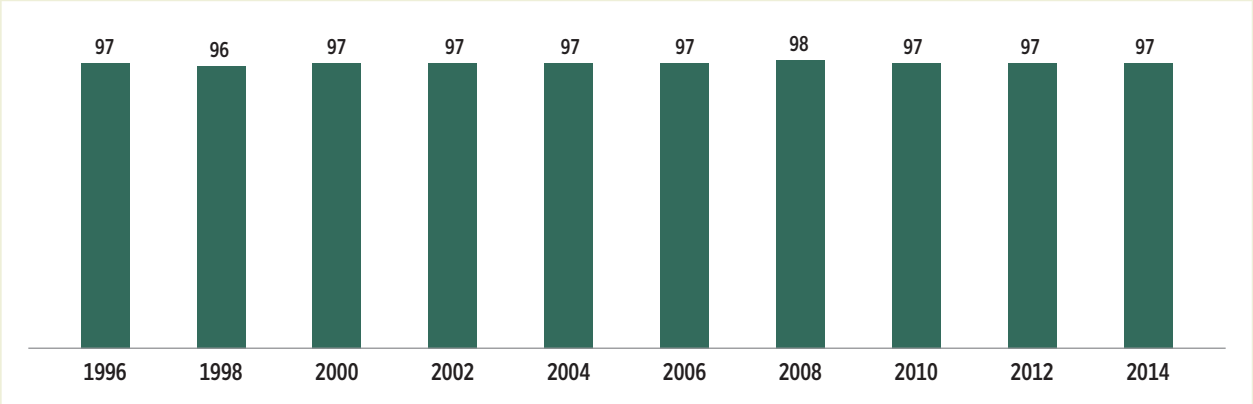
Independent Directors' Prior Affiliation with Complex

The 1940 Act provides that an individual is an "interested person" if he or she has certain personal, financial, or professional relationships with the fund, investment adviser, or principal underwriter. The SEC also may issue an order finding that a director who has had a material business or professional relationship with the fund, adviser, or principal underwriter within the past two fiscal years is an interested person.[13] ICI's *Best Practices Report* recommends always treating former officers or directors of the adviser, underwriter, or certain affiliates as interested persons in order to avoid any possible perception that such a director might not act in the best interests of shareholders. The studies reflect an appreciation for the letter and spirit of the law and industry best practices, as 97 percent of independent directors surveyed report never having been previously employed by the complex (Figure 13).

FIGURE 13

Independent Directors Never Previously Employed by Complex

Percentage of directors, 1996–2014



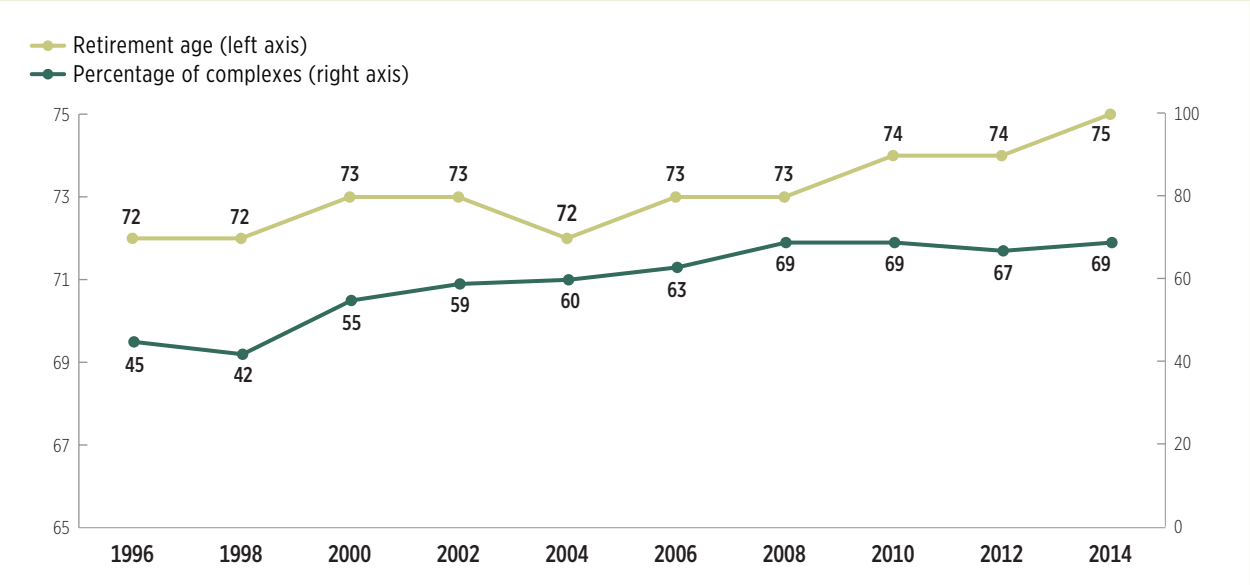
Mandatory Retirement Policy

No regulatory requirement relating to retirement policies exists for fund directors, but the topic may be addressed in a board's annual self-assessment. The studies began collecting data regarding mandatory retirement policies in 1996. Since then, the percentage of complexes that have formally adopted such policies has increased gradually, and stood at 69 percent in 2014 (Figure 14). ICI's *Best Practices Report* recommends that fund boards adopt policies on the retirement of directors, but declined to specify the type of policy (e.g., retirement age, term limits) or a recommended retirement age. For those complexes with a mandatory retirement policy, the average mandatory retirement age has increased slowly from 72 in 1996 to 75 in 2014.

FIGURE 14

Mandatory Retirement Policy

1996–2014



To help put a director's average retirement age in context, previous studies included the age of all independent directors participating in each biennial study and the number of years they had served their complexes as directors. Since 1996, the average age has edged up from 62 to 66 (Figure 15), and the average number of years of service has increased from nine to 12 years (Figure 16).

FIGURE 15

Average Age of Independent Directors

1996–2014

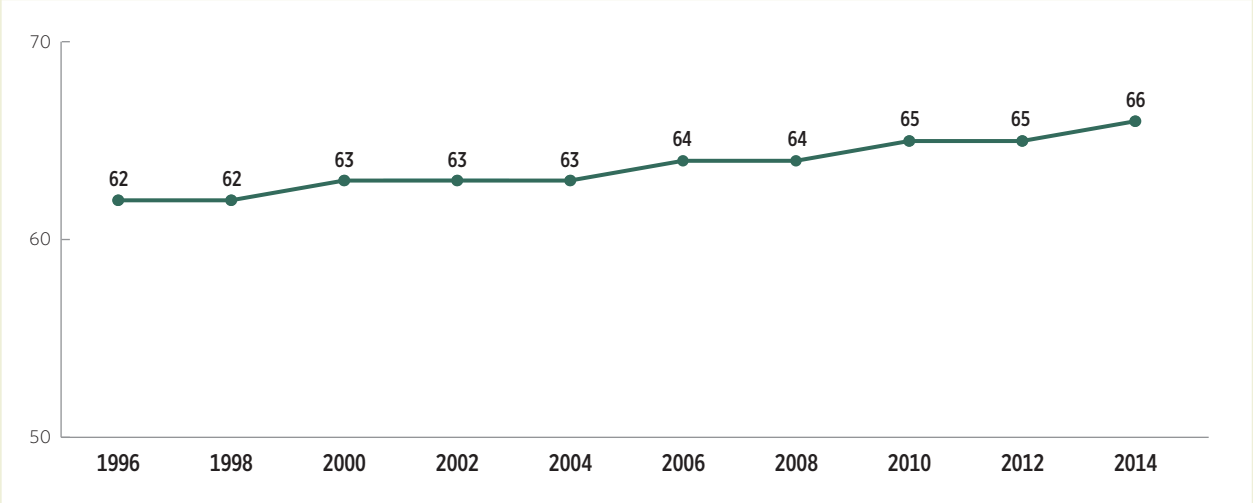
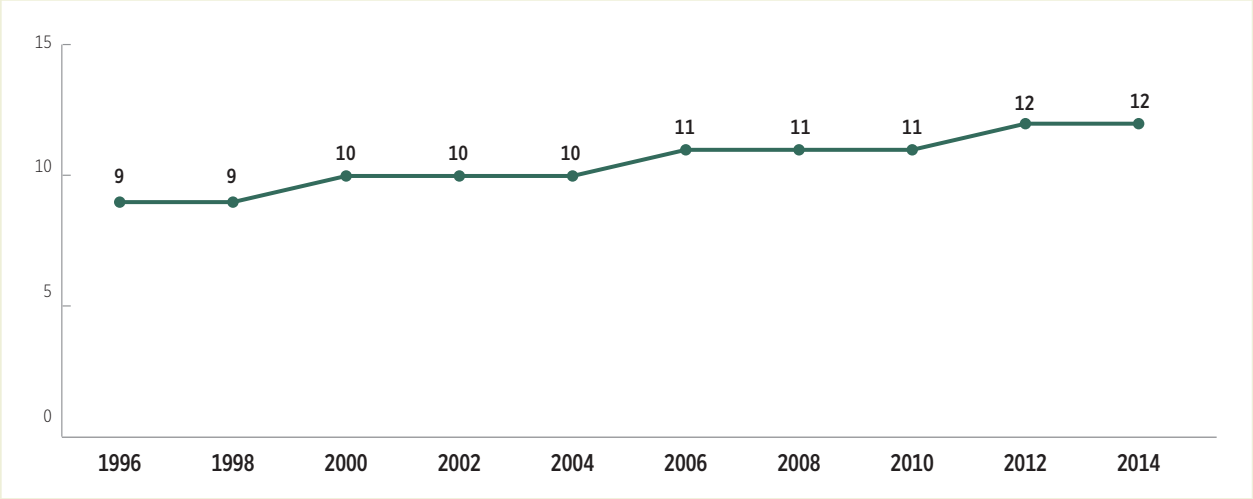


FIGURE 16

Length of Service at Complex by Independent Directors

Number of years, 1996–2014



Independent Counsel

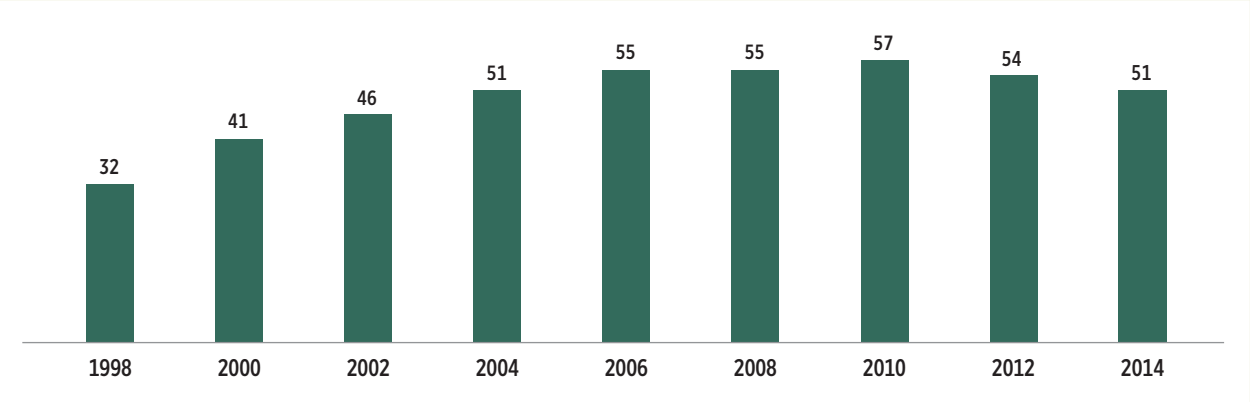
Fund boards employ a variety of arrangements in retaining counsel. Some independent directors have their own dedicated counsel, others formally retain counsel with the fund, and still others have no dedicated counsel but instead rely on counsel to the fund (or retain other counsel) on an as-needed basis. ICI's *Best Practices Report* recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The report acknowledges that independent directors may elect to have their own counsel or rely on counsel to the fund and, as the data demonstrate, independent directors increasingly recognize this practice as a key component of effective fund governance. The 2001 SEC Rules further provide that, if the independent directors were to have counsel, it must be "independent legal counsel" as defined, but they decline to mandate representation.

The studies have collected data concerning director retention of counsel and, though the form of the query in the survey questionnaire has varied, certain trends emerge. The data show that instances in which independent directors retain their own counsel—separate from fund counsel and the adviser's counsel—have increased from 32 percent of participating complexes in 1998 to 51 percent in 2014 (Figure 17). These instances include arrangements in which the fund, adviser, and directors are served by different counsel, as well as arrangements in which the fund and adviser share counsel, but the independent directors have separate, dedicated counsel.

FIGURE 17

Independent Directors Have Dedicated Counsel

Percentage of complexes, 1998–2014

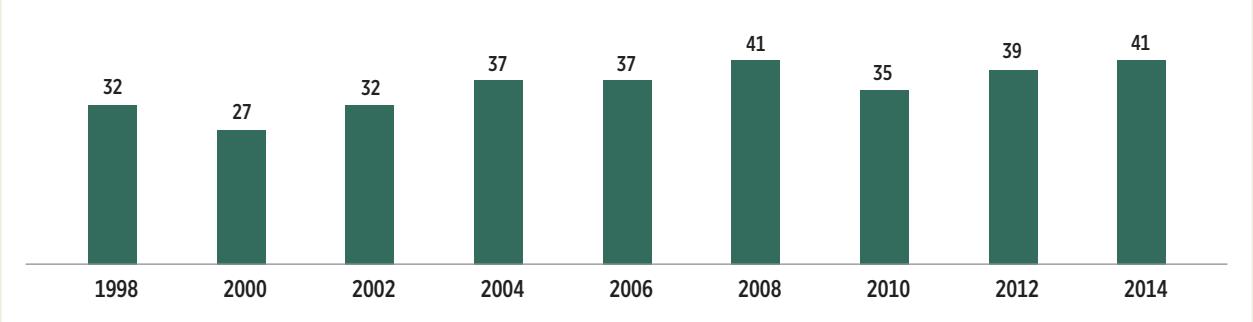


In instances where independent directors formally or informally rely on counsel to the fund, while the adviser is served by different counsel, the fund counsel would constitute independent legal counsel. In 2014, 41 percent of the complexes reported that independent directors rely on fund counsel (Figure 18).

FIGURE 18

Independent Directors Rely on Fund Counsel (Different from Adviser's Counsel)

Percentage of complexes, 1998–2014

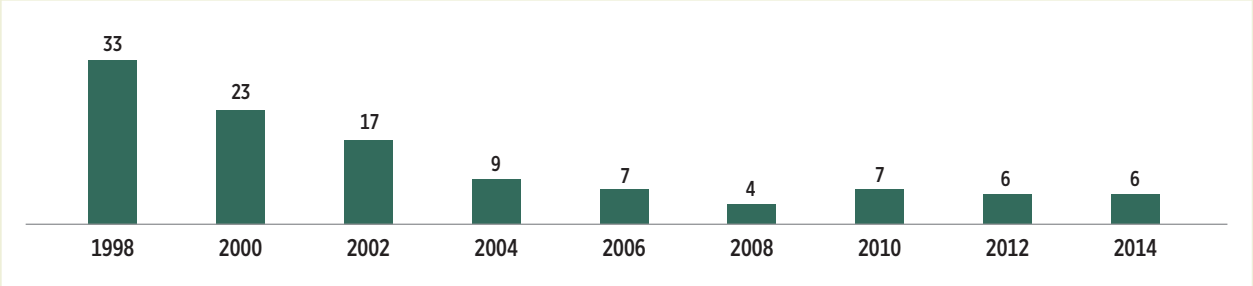


The percentage of complexes indicating that independent directors are not represented by counsel—and are not formally or informally relying on counsel to the fund—has declined sharply since 1998 (Figure 19). This decline was likely influenced by a number of factors, including ICI's *Best Practices Report,* the 2001 SEC Rules relating to independent counsel, and, most recently, the focus on director independence following the 2004 SEC Rules and litigation involving funds.

FIGURE 19

Same Counsel Represents Fund and Adviser: Independent Directors Have No Separate Counsel

Percentage of complexes, 1998–2014



The data permit us to conclude that an increasing number of independent directors are represented by independent legal counsel. In fact, the total percentage of complexes indicating that independent directors either are represented by dedicated counsel or counsel separate from the adviser's has increased steadily since the release of ICI's *Best Practices Report,* from 68 percent in 2000 to 92 percent in 2014 (Figures 17 and 18). Given the increased amount of regulatory compliance matters being addressed by fund boards, such representation is beneficial to both the independent directors and the shareholders they represent.

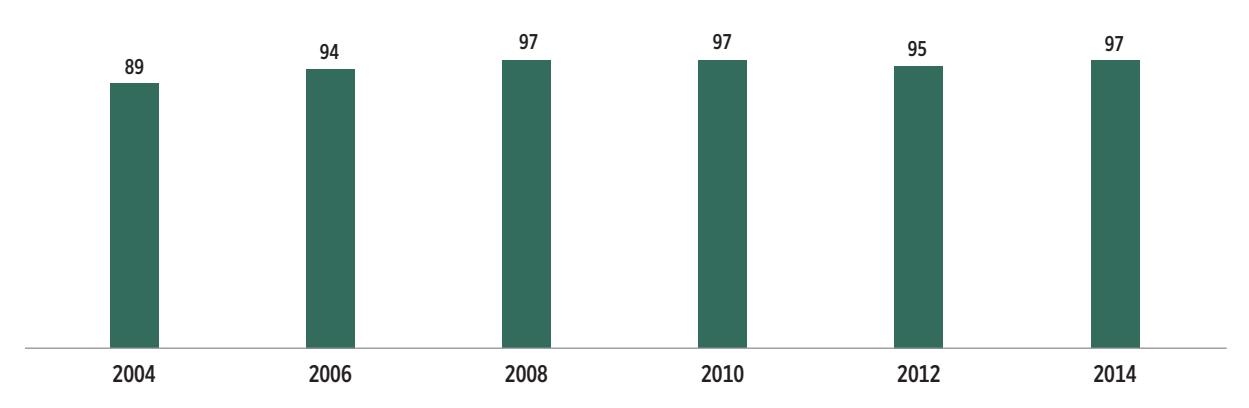
Audit Committee Financial Expert

In 2003, the SEC adopted rules that require funds to disclose whether they have at least one financial expert serving on the audit committee of the board and, if so, the name of the expert and whether the expert is independent of management. Funds that do not have an audit committee financial expert must disclose the reasons why.[14] Based on the new requirement, beginning in 2004, the studies include data on whether complexes have an audit committee financial expert. The vast majority (97 percent) of complexes have a financial expert serving on an audit committee, notwithstanding that they are not required to do so (Figure 20).

FIGURE 20

Complexes with Audit Committee Financial Expert

Percentage of complexes, 2004–2014



Conclusion

Fund governance practices have continued to evolve in response to emerging industry standards and often well in advance of, or in the absence of, explicit regulatory requirements. ICI and IDC will continue to document these and other trends in fund governance practices through their studies and will publish updated overviews every two years in conjunction with the biennial collection of data.

Additional Reading

IDC has issued the following white papers, each of which provides practical guidance to boards. The papers are available on IDC's website at http://www.idc.org/idc/pubs/white_papers.

- *Report on Funds' Use of Proxy Advisory Firms* (January 2015)
- *Considerations for Board Composition: From Recruitment Through Retirement* (October 2013)
- *Investment Performance Oversight by Fund Boards* (October 2013)
- *Board Oversight of Exchange-Traded Funds* (October 2012)
- *Fund Board Oversight of Risk Management* (September 2011)
- *Board Oversight of Target Retirement Date Funds* (April 2010)
- *Board Oversight of Subadvisers* (January 2010)
- *Board Oversight of Fund Compliance* (September 2009)
- *Navigating Intermediary Relationships* (September 2009)
- *Board Oversight of Derivatives* (July 2008)
- *Oversight of Fund Proxy Voting* (July 2008)
- *Board Oversight of Certain Service Providers* (June 2007)
- *Board Consideration of Fund Mergers* (June 2006)
- *Fair Valuation Series: The Role of the Board* (January 2006)
- *Fair Valuation Series: An Introduction to Fair Valuation* (June 2005)
- *Director Oversight of Multiple Funds* (May 2005)
- *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005)
- *Implementing the Independent Chairperson Requirement* (January 2005)

Notes

[1] ICI and IDC collect data on board practices from participating fund complexes through the *Directors Practices Study: Practices and Compensation.* The first such study, conducted in 1995, collected data covering the year ended December 31, 1994, and 4,048 funds were represented. Subsequent studies covered 1996 (5,191 funds), 1998 (6,452 funds), 2000 (7,740 funds), 2002 (8,073 funds), 2004 (7,549 funds), 2006 (7,764 funds), 2008 (7,690 funds), 2010 (7,756 funds), 2012 (8,235 funds), and 2014 (8,841 funds). This overview will use the term "studies" to refer to all of the biennial studies collectively; results that are unique to a particular study will be identified by year.

[2] Investment Company Institute, *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (June 24, 1999).

[3] ICI and IDC, *Overview of Fund Governance Practices, 1994–2012*.

[4] Securities and Exchange Commission, Investment Company Act Release No. 24816 (January 2, 2001).

[5] Securities and Exchange Commission, Investment Company Act Release No. 26520 (July 27, 2004). The 2001 and 2004 SEC Rules imposed conditions on fund boards that rely on any one of 10 popular exemptive rules. Most funds rely on at least one of these rules. Accordingly, this overview will discuss the conditions as generally applying to all funds. Because the 2004 SEC Rules mandate certain fund governance practices that were previously optional (i.e., that boards conduct self-assessments and that independent directors meet in separate sessions), we have discontinued collecting data regarding those mandated practices and do not include such data in this overview.

[6] *Chamber of Commerce v. Securities and Exchange Commission*, 443 F.3d 890 (DC Cir. 2006). In 2005, the court stayed the effectiveness of the rule amendments requiring boards to be composed of 75 percent independent directors and have an independent chair until the litigation was concluded. See *Chamber of Commerce v. Securities and Exchange Commission*, No. 05- 1240 (DC Cir. August 10, 2005).

[7] Securities and Exchange Commission, Investment Company Act Release No. 27395 (June 13, 2006) and Investment Company Act Release No. 27600 (December 15, 2006).

[8] See 2001 SEC Rules, supra note 4, and 2004 SEC Rules, supra note 5.

[9] See *Chamber of Commerce v. Securities and Exchange Commission*, supra note 6.

[10] The frequency of board meetings is a topic that may be evaluated as part of the annual board self-assessment mandated by the 2004 SEC Rules. See also IDC Task Force Report, *Board Self-Assessments: Seeking to Improve Mutual Fund Board Effectiveness* (February 2005).

[11] See *Chamber of Commerce v. Securities and Exchange Commission*, supra note 6.

[12] Certain complexes with cluster boards have an independent board chair and an independent lead director, and are included in both measures in Figure 11. Accordingly, the percentage of complexes having either an independent board chair or an independent lead director is less than the sum of these two measures.

[13] Under Section 2(a)(19) of the 1940 Act, the SEC also may issue an order finding a person who had a material or professional relationship with the principal executive officer of the fund, investment adviser, or principal underwriter; with any other fund having the same investment adviser, principal underwriter, or the principal executive officer of such fund; or with any controlling person of the investment adviser or principal underwriter, within the past two fiscal years, to be an interested person.

[14] Securities and Exchange Commission, Investment Company Act Release No. 25914 (January 27, 2003).

The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards by all industry participants; advance the interests of funds, their shareholders, directors, and advisers; and promote public understanding of mutual funds and other investment companies.

The Independent Directors Council (IDC) serves the fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role.

1401 H Street, NW, Washington, DC 20005-2148 202-326-5800

HOME

SEC Staff Guidance on Mutual Fund Distribution and Sub-Accounting Fees

Margery K. Neale
Dianne E. O'Donnell
Willkie Farr & Gallagher LLP

In January 2016, the SEC's Division of Investment Management (the "Division of IM") published a Guidance Update (the "Guidance"), containing the staff's views and recommendations relating to mutual fund distribution and sub-accounting fees.[1] The Guidance defines "sub-accounting fees" to include sub-transfer agent, administrative and other shareholder servicing fees.[2] The issuance of the Guidance follows a sweep examination, conducted as a joint initiative by OCIE and a number of other SEC offices and divisions, of mutual fund complexes, investment advisers, broker-dealers, and transfer agents that primarily focused on the payment of fees to financial intermediaries for services that are characterized as non-distribution-related sub-accounting services.

Specifically, the staff states in the Guidance that the sweep examinations raised questions as to whether, in some cases, a portion of the sub-accounting fees paid by funds may have been used to pay for activities that are primarily intended to result in the sale of mutual fund shares and therefore should have been paid pursuant to a plan adopted in accordance with Rule 12b-1 under the Investment Company Act of 1940, as amended (the "1940 Act").[3] Rule 12b-1 prohibits a mutual fund from engaging, directly or indirectly, in the financing of any activity which is primarily intended to result in the sale of fund shares except pursuant to a 12b-1 plan. The Guidance notes that "this prohibition applies not only to payments that are clearly identified as distribution fees, but also to payments that are ostensibly made for some other purpose but which, based on the facts and circumstances, are used in ways that finance distribution."[4]

The Guidance is intended to clarify and update prior SEC and staff guidance with respect to service fees paid to financial intermediaries. It reaffirms that while Rule 12b-1 does not prohibit payments to intermediaries for non-distribution-related purposes, the fund board "bear[s] substantial responsibility for determining whether fees [directly or indirectly] paid by a

---

1 *See* IM Guidance Update No. 2016-01, *Mutual Fund Distribution and Sub-Accounting Fees* (Jan. 2016), available at: https://www.sec.gov/investment/im-guidance-2016-01.pdf.

2 The Guidance includes as examples of services covered by sub-accounting fees the following: (i) communicating with customers about fund holdings; (ii) maintaining financial records; (iii) processing changes in customer accounts and trade orders; (iv) recordkeeping for customers; (v) answering customer inquiries regarding account status and the procedures for the purchase and redemption of fund shares; (vi) providing account balances and providing account statements, tax documents and confirmations of transactions in a customer's account; (vii) transmitting proxy statements, annual reports and other communications from a fund; and (viii) receiving, tabulating and transmitting proxies executed by customers.

3 The Guidance notes that as a result of the sweep, the SEC recently brought an enforcement action against an adviser that caused a fund to pay for certain specific distribution-related activities outside of a 12b-1 plan. *See In the matter of First Eagle Investment Management, et al.*, Investment Company Act Release No. 4199 (Sep. 21, 2015).

4 Guidance.

mutual fund are for distribution."[5] In that regard, the Guidance notes that the board's role "should focus on understanding the overall distribution process as a whole to inform its reasonable business judgment about whether sub-accounting and other mutual-fund paid fees represent payments for distribution in whole or in part."[6]

To that end, the Guidance recommends:

- "Regardless of whether a fund has, or is considering adopting, a 12b-1 plan, mutual fund boards of directors have a process in place reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution.

- As part of this process, advisers and other relevant service providers [such as fund transfer agents, distributors and administrators, to the extent they have relevant information or obligations] provide sufficient information to inform the board of the overall picture of intermediary distribution and servicing arrangements for the mutual fund, including how the level of sub-accounting fees may affect other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution.

- Advisers and other relevant service providers inform boards if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees, and if they do, boards evaluate the appropriateness and character of those payments with heightened attention."[7]

The staff's three recommendations are discussed more fully below.

I. Board Process

The Guidance states that the staff "recommends that regardless of whether a mutual fund has, or is considering adopting a 12b-1 plan, fund boards of directors have a process in place reasonably designed to assist them in evaluating whether a portion of fund-paid sub-accounting fees, if paid to intermediaries that distribute fund shares, is being used to pay directly or indirectly for distribution."[8] The staff further recommends that "advisers and relevant service providers provide or arrange for the provision to boards any necessary information to assist boards in this evaluation process."[9]

---

5 *Id*. *See also Investment Company Institute,* SEC No-Action Letter (Oct. 30, 1998) (the "*ICI Letter*") (concluding that "[a] fund's board of directors . . . has the responsibility to determine whether any portion of a [ ] fee that is directly or indirectly paid by the fund is *primarily for distribution* and, if so, to ensure that any such payments are made pursuant to a rule 12b-1 plan." (emphasis added).

6 Guidance.

7 *Id*. (notes omitted).

8 *Id*.

9 *Id*.

The Guidance notes that many boards already have established processes in place to assist them in evaluating sub-accounting fees, which may be based on a 1998 letter from the staff to the ICI relating to the participation of mutual funds in fund supermarkets (defined earlier as the "ICI Letter").[10] The ICI Letter stated that "[t]he board should determine whether the portion of the fee that is paid by the fund for non-distribution services is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders, and (b) the payments that the fund would be required to make to another entity to perform the same services."[11] The factors identified in the ICI Letter as being relevant to the board's determination included: (i) the nature of the services provided; (ii) whether the services provide any distribution benefits; (iii) whether the services provide non-distribution related benefits and are typically provided by fund service providers; (iv) the costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total amount of the fee; and (v) the characterization of the services by the intermediary.[12] The Guidance states that the same types of factors and analysis as described in the ICI Letter may serve as a useful framework in establishing a process by which a fund's board evaluates sub-accounting fees, while noting that "not all of the factors listed in the [ICI Letter] may be 'relevant' to an evaluation of the character of sub-accounting fees, and therefore a board need not consider every factor stated in the [ICI Letter] if not relevant to an evaluation of the character of sub-accounting fees."[13]

In applying the framework from the ICI Letter to a process for evaluating the character of sub-accounting fees, the Guidance states that the information that a board may consider requesting from advisers, other relevant service providers and intermediaries may include, without limitation:

- Information about the specific services provided under the fund's sub-accounting agreements;
- The amounts being paid;
- Whether the adviser or other service providers are recommending any changes to the fee structure or whether any of the services provided have materially changed;
- Whether any of the services could have direct or indirect distribution benefits;
- How the adviser and other service providers ensure that the fees are reasonable; and
- How the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).

---

10 *See ICI Letter*, *supra* note 5.

11 *Id*.

12 *Id*.

13 Guidance.

According to the Guidance, while this information may usually be provided when the board considers implementing or continuing a 12b-1 plan or as part of the Section 15(c) contract review process, if there are material changes to the fund's distribution structure, or changes to the distribution arrangements that may pose a material conflict of interest for the adviser, the staff believes that the board should receive and consider such information on a more timely basis in order to inform the board's evaluation of sub-accounting fees.[14]

In addition, the Guidance notes that if a board implements limitations on the maximum allowable sub-accounting fees to be paid with fund assets (*i.e.*, a cap), it should carefully evaluate any benchmarks used to establish the cap and whether the benchmark takes into account relevant economies of scale and the comparability of the type and amount of services provided. It points out that boards may want to also consider "different payment rates or fee caps to intermediaries depending on the varying kinds of services provided to the mutual fund."[15]

In a related matter, the Guidance notes that, during the sweep examination, "the staff observed that many mutual funds did not have explicit policies and procedures as part of their [R]ule 38a-1 compliance programs designed to prevent violation of [S]ection 12(b) and [R]ule 12b-1."[16] According to the Guidance, all funds should have compliance policies and procedures relating to Section 12(b). Funds with a 12b-1 plan "should have adequate policies and procedures for reviewing and identifying any payments that may be for distribution-related services that are not paid through the plan."[17] Funds without a 12b-1 plan "should also have policies and procedures reasonably designed to prevent violations of [S]ection 12(b) and [R]ule 12b-1."[18]

II. Providing Boards an Overall Picture of Distribution and Servicing Arrangements

As part of the board process described above, the Guidance recommends that investment advisers and other relevant service providers provide "sufficient information" to inform the board of the overall picture of the intermediary distribution and servicing arrangements for the funds, including how the level of sub-accounting fees may affect other payment flows that are intended for distribution (*e.g.*, 12b-1 fees, revenue sharing). The process should also be reasonably designed to provide the board enough information so it can (a) make an informed

---

14 The Guidance notes that while certain of the factors set forth in the 1980 adopting release for Rule 12b-1 "may no longer be pertinent" to a board's evaluation of whether to approve or continue a 12b-1 plan, "other factors not included in that release may be. Accordingly, in the staff's view, it would not be necessary for boards to make a finding about *each* of the factors laid out in the 12b-1 [a]dopting [r]elease if such factors are not pertinent to boards' evaluation of whether a 12b-1 plan should be implemented or continued in the current environment. On the other hand, the staff believes that boards should consider, and keep appropriate records of their consideration, other pertinent factors, even those not noted in the 12b-1 [a]dopting [r]elease, if they form the basis for their decision to use fund assets for distribution." (emphasis in original). *Id*. at note 23.

15 *Id*.

16 *Id*.

17 *Id*.

18 *Id*.

judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution; and (b) evaluate whether and to what extent sub-accounting payments may reduce or otherwise affect advisers' or their affiliates' revenue sharing obligations, or the level of fees paid under a 12b-1 plan.

III. Indicia that a Payment May be Used to Pay for Distribution

The Guidance notes that investment advisers and other relevant service providers should inform boards if certain activities or arrangements that are potentially distribution-related exist in connection with the payment of sub-accounting fees and, if they exist, the board should evaluate the appropriateness of those payments "with heightened attention." The Guidance recommends that investment advisers and relevant service providers affirmatively provide the mutual fund board with information as to whether activities identified in the Guidance (and listed below) occur and, if so, the board should "closely scrutinize the appropriateness and distribution character of such payments as part of its evaluation."[19] The activities in question are:

- Distribution-related activities that are conditioned on the payment of sub-accounting fees;
- The payment of fund distribution expenses when the fund lacks a 12b-1 plan;
- Tiered payment structures (*e.g.*, where payments are first made from Rule 12b-1 fees, then fund-paid sub-accounting fees, and finally the balance by the adviser or an affiliate from revenue sharing), and whether fund-paid fees reduce or subsidize any fees that the adviser and other relevant service providers might otherwise be responsible for, "which would be a conflict of interest";
- Lack of specificity or bundling of services, which precludes the board's ability to determine whether specific fees are primarily for distribution-related services;
- The adviser taking distribution and sales benefits into account when recommending, instituting, or raising sub-accounting fees;[20]
- Large disparities in sub-accounting fees paid to intermediaries, particularly when higher fees for the services are being paid to the mutual fund's newest, largest, or fastest-growing distribution partners; and
- Fees paid for "sales data" and whether the purchase of such data is distribution related.

---

[19] *Id*. The Guidance acknowledges that while none of these activities "may demonstrate in and of itself that a non-12b-1 payment is for distribution-related activity," they should warrant further scrutiny.

[20] The Guidance notes that when employees of the adviser or other service providers whose primary job is distribution are involved in negotiating the level of sub-accounting fees, "it heightens the risk that distribution benefits or services are in part driving the arrangement." *Id*.

In the Guidance, the staff acknowledges that mutual fund boards typically are not involved in the day-to-day negotiation of sub-accounting agreements with intermediaries. Accordingly, the Guidance notes that the staff "expects that mutual fund directors could receive and rely on the assistance of outside counsel, the fund's chief compliance officer, or personnel from the adviser or relevant service providers, as appropriate," to fulfill their responsibilities.[21] According to the staff, "an effective way to obtain an overall picture of the fund's intermediary arrangements might be to have the adviser or relevant service providers furnish information in such a way that allows fund directors to understand the relevant conflicts and the general context within which the arrangements are made, as well as the specific details of atypical or particularly significant arrangements."[22]

---

[21] *Id.*

[22] *Id.*

November 2, 2010

Ms. Dorothy A. Berry
Chair - Governing Council
Independent Directors Council
1401 H Street, NW
Suite 1200
Washington, D.C. 20005

Ms. Jameson A. Baxter
Chair
Mutual Fund Directors Forum
1501 M Street, NW
Suite 1150
Washington, D.C. 20005

Dear Ms. Berry and Ms. Baxter:

In connection with an ongoing review of fund directors' duties under the Investment Company Act of 1940 (the "Act") by the Division of Investment Management (the "Division"),[1] we understand that there may be some confusion regarding fund directors' responsibilities to make determinations under Rules 10f-3, 17a-7 and 17e-1 under the Act. We therefore are providing the following guidance.

A number of provisions of the Act and rules thereunder rely on fund boards to protect fund shareholders in conflict of interest situations.[2] In particular, Section 10(f) of the Act prohibits a fund from engaging in certain affiliated transactions, and Sections 17(a) and 17(e) of the Act prohibit affiliated persons of a fund from engaging in certain affiliated transactions.[3] Certain

---

[1] This review was informally referred to by the Division's Director, Andrew J. Donohue, as the "Director Outreach Initiative." During the course of the Director Outreach Initiative, Director Donohue attended numerous meetings with fund boards, and the Division received many comments and recommendations from fund boards and other interested parties, including you. *See* Comment Letter of Independent Directors Council (Feb. 26, 2008), *available at* http://www.ici.org/pdf/22275.pdf and Comment Letter of the Mutual Fund Directors Forum (May 2, 2008), *available at* http://www.mfdf.org/images/uploads/newsroom/DirectorDutiesMFDFLetterMay22008.pdf.

[2] Congress mandated a specific role for fund directors and assigned them certain responsibilities to oversee conflicts. In particular, Congress mandated a specific role for independent directors. In an often-cited decision, the Supreme Court, in examining the legislative history of the Act, elaborated: "Congress' purpose in structuring the Act as it did is clear. It 'was designed to place the unaffiliated directors in the role of 'independent watchdogs.'" Burks v. Lasker, 441 U.S. 471, 484 (1979) (quoting Tannenbaum v. Zeller, 552 F.2d 402, 406 (2d Cir. 1977)). The Court further noted, "[the unaffiliated directors] would 'furnish an independent check upon the management' of investment companies." *Id.* (quoting *Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce,* 76th Cong., 3d Sess., 109 (1940)).

[3] Section 10(f) of the Act generally prohibits a fund from acquiring securities during an underwriting syndicate in which an affiliated person of the fund is participating. Section 17(a) of the Act generally prohibits an affiliated person of a fund from knowingly selling any security to, or knowingly purchasing

rules promulgated under these sections, including Rules 10f-3,[4] 17a-7[5] and 17e-1,[6] give fund boards the authority to permit various types of otherwise prohibited transactions without prior review and approval by the Securities and Exchange Commission (the "Commission") of individual exemptive applications.

Rules 10f-3, 17a-7 and 17e-1 each require a fund board to make a determination, no less frequently than quarterly, that each transaction made during the preceding quarter was effected in compliance with procedures reasonably designed to provide that the transactions comply with the requirements of the relevant rule. We understand that some fund boards believe that, especially in light of the subsequent adoption by the Commission in 2003 of Rule 38a-1 under the Act (otherwise known as the compliance rule),[7] a fund board can delegate its responsibility to make the determinations required under these rules. We disagree.

The Commission, in adopting Rules 10f-3, 17a-7 and 17e-1 did not provide that a fund board's determinations under each of these rules could be delegated.[8] Rather, the clear wording

---

any security from, the fund in a principal transaction. Section 17(e) of the Act generally prohibits an affiliated broker of a fund from effecting fund transactions on a securities exchange if the affiliated broker receives a commission, fee or other remuneration that exceeds the "usual and customary broker's commission."

4 Rule 10f-3 under the Act permits a fund to purchase securities from an affiliated syndicate as long as certain conditions are satisfied. Rule 10f-3 requires that the fund's board, including a majority of independent directors, approves procedures that are reasonably designed to provide that the Rule 10f-3 transactions comply with the conditions of the rule, approves changes to the procedures as the board deems necessary, and determines no less frequently than quarterly that all Rule 10f-3 transactions made during the preceding quarter were effected in compliance with the approved procedures.

5 Rule 17a-7 under the Act provides an exemption from Section 17(a)'s prohibitions so long as certain conditions are met. Rule 17a-7 requires that a fund's board, including a majority of the independent directors, adopts procedures that are reasonably designed to provide that the Rule 17a-7 transactions comply with the conditions of the rule, approves changes to the procedures as the board deems necessary, and determines no less frequently than quarterly that all Rule 17a-7 transactions made during the preceding quarter were effected in compliance with the approved procedures.

6 Rule 17e-1 under the Act provides that a commission, fee or other remuneration will not be deemed to exceed the "usual and customary broker's commission" if, among other things, the commission, fee or other remuneration is "reasonable and fair" compared to the commission, fee or other remuneration received by other brokers in connection with comparable transactions involving similar securities during a comparable period of time. Rule 17e-1 requires that the board of directors, including a majority of independent directors, adopts procedures that are reasonably designed to provide that a commission, fee or other remuneration is consistent with the requisite rule standard, approves changes to the procedures as the board deems necessary, and determines no less frequently than quarterly that all Rule 17e-1 transactions made during the preceding quarter were effected in compliance with the approved procedures.

7 *See Compliance Programs of Investment Companies and Investment Advisers*, Investment Company Act Release No. 26299 (Dec. 17, 2003).

8 Where the Commission has wanted to permit delegation in connection with these rules, it has done so clearly. In amendments to each of these rules, the Commission stated that boards may delegate to a

of each rule provides that the board itself must make such determinations. These rules, however, do not specify how fund boards should make such determinations. These rules do not specifically require the directors to review each transaction in order to make the required determinations.

We believe that fund boards may, where consistent with the prudent discharge of their fiduciary duties, make these determinations in reliance on summary quarterly reports of the transactions effected in reliance on one or all of these rules in the prior quarter. Consistent with this guidance, some fund boards may decide that it is necessary or appropriate to review each transaction in order to make the required determinations under each relevant rule. For example, boards to those funds with fewer transactions may determine to review each transaction. Other fund boards may decide to make the required determinations based on summary quarterly reports (prepared by the fund's chief compliance officer ("CCO") or other designated persons) of the transactions effected in reliance on one or all of these rules in the prior quarter.[9] For some boards, the fund's CCO may be the appropriate person to provide the boards with such summary reports. In addition, under appropriate circumstances, fund boards also would have the flexibility to tap other relevant expertise to assist in the quarterly review process (*e.g.*, some combination of fund counsel, counsel to the independent directors, investment adviser personnel, and/or independent third parties).[10]

---

directorial committee or other persons associated with the fund the task of drafting the relevant procedures for the board's consideration. For example, with regard to Rule 10f-3, the Commission stated:

> The board of directors may delegate to a directorial committee or other persons associated with the investment company the drafting task of preparing recommended procedures to be considered by the board as a whole. Of course, the board is responsible for any procedures that it ultimately chooses. See Lasker v. Burks, 47 U.S.L.W. 4494, 4496 n.10 (May 15, 1979) (minimum standards applying to decisions which investment company directors may be called upon to make). Moreover, in considering whether to adopt a particular set of procedures, the board may wish to request from the initial draftsmen all information as may reasonably be necessary to determine if the proposed procedures would comply with the requirements of paragraph (h)(1) of the rule. *See Exemption of Acquisition of Securities During the Existence of Underwriting Syndicate*, Investment Company Act Release No. 10736 n. 6 (June 14, 1979).

9 It is important to note that, even if fund boards do not review the details of each transaction under these rules, boards nonetheless should have a process in place reasonably designed to ensure that transactions are effected in a manner that is consistent with the board-approved procedures and the relevant rules. *See* Rule 38a-1. We note that transactions under Rules 10f-3, 17a-7 and 17e-1 may also raise issues under other provisions of the federal securities laws that may need to be addressed as part of a fund's compliance procedures. For example, as we stated in a prior no-action letter, "[b]efore causing funds that it manages to enter into 17a-7 transactions, an investment adviser should carefully consider, among other things, its duty to seek best execution for each fund and its duty of loyalty to each fund." *See* Federated Municipal Funds, SEC No-Action Letter (Nov. 20, 2006).

10 In this regard, state law generally requires directors to have a reasonable basis to rely on others. *See*, *e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 2-405.1 (2010); Mass. Gen. Laws Ann. ch. 156B, § 65 (2010); DEL. CODE ANN. tit. 8, § 141 (2010).

Even if boards rely on the CCO or others, consistent with this guidance, to provide them with summary quarterly reports of the transactions effected in reliance on Rules 10f-3, 17a-7 and 17e-1, we emphasize that boards still retain ultimate responsibility for making the quarterly determinations required by these three rules, and boards cannot delegate such responsibility. As a result, even if the directors rely on others to investigate the details of each transaction, they need to be appropriately vigilant to ensure that they have sufficient information to be alerted to issues raised by these conflict transactions.[11] In addition, because directors may be heavily reliant on others with respect to these transactions, it is essential that all involved in reviewing these conflicts transactions and in preparing summary reports do so diligently.[12]

****

We hope that this guidance clarifies our views regarding fund boards' quarterly review obligations under Rules 10f-3, 17a-7 and 17e-1 under the Act. We would appreciate your sharing this letter with your members.

Michael S. Didiuk
Attorney-Adviser

---

[11] We are concerned that some commenters have characterized the current process as "mechanical."

[12] In another context, the staff commented on the fund board's review and evaluation of conflict transactions:

> Meaningful dialogue is particularly important where the board is evaluating the types of transactions permitted by the Exemptive Rules [including these three rules]. A board can most effectively manage the conflicts of interest inherent in these transactions where the board culture encourages rather than stifles open and frank discussion of what is in the best interest of the fund. This is especially true in connection with the conflicts of interest presented by these transactions because the best interest of the fund frequently is different from the best interest of the fund's management company. Staff Report to the U.S. Securities and Exchange Commission, *Exemptive Rule Amendments of 2004: The Independent Chair Condition*, April 2005.

SESSION 2-B: Do You Know What's Lurking in Your Data? The SEC Can Tell You

Erozan Kurtas (2012)

- "The future is more about the machines."
- "Most compliance personnel do not have the background to understand, monitor, or test models."
- "Models and systems evolve faster than risk or compliance processes."
- **"In my opinion, traditional compliance needs to become Quantitative Compliance; Financial Engineering requires Compliance Engineering."**

"Meet the SEC's Brainy New Crime Fighters: Quants are Agency's Latest Weapon Against Financial Misdeeds" (WSJ December (2014)

- The SEC, "which is known for its platoon of lawyers with little experience in math or coding, **is hiring more employees versed in computer programming and mathematics and pressing the old guard to get up to speed with the new methods."**
- "What would have previously taken us weeks or even months to do, now sometimes takes minutes or hours."

Pamela Dyson, SEC CIO (July 2015)

- The SEC's Market Information and Data Analysis System (MIDAS) collects **1 billion records every day**.
- These records are time stamped to the microsecond.
- MIDAS enables the SEC to analyze **100 billion records at a time.**

OCIE

- 2015 and 2016 Priorities of the National Examination Priority include: "Using data analytics to identify signals of potential illegal activity" including "potential breaches of fiduciary obligations."
- "Just give me your data."
- *"Broker-Dealer Controls Regarding Sales of Structured Securities Products"* (OCIE Risk Alert, August 2015) – Data was mined from 26,000 sales of structured products to document violations at 10 broker-dealers' branch offices involving suitability and supervisory violations.

SEC Chief of Staff: "Embracing Data and Technology" NRS Speech (October 2015)

- "OCIE has incorporated state of the art technology to collect and analyze large data sets . . . Exam teams increasingly utilize the 'National Exam Analytics Tool,' or 'NEAT.' which was developed **by highly skilled PhDs and technologists** in OCIE's Quantitative Analytics Unit . . ."

- "OCIE's Risk Analytics Examination Group is continuing to leverage technology . . . and then using that data to identify potential problematic behavior . . . including unsuitable recommendations, misrepresentations, inadequate supervision, churning, and reverse churning."

SEC: Enforcement

» According to the "Analytics" section of the SEC's Enforcement Results for FY 2015, the SEC "Charged 87 parties in cases involving trading on the basis of inside information. Many of these cases involved complex insider trading rings which were cracked by Enforcement's ***innovative uses of data and analytics to spot suspicious trading.***" (October 2015) [Emphasis added.]

Welcome to the Brave New World of Data!

Panelists

- Tamara Salmon, Investment Company Institute
- Robert Dearman, Jackson National Life Insurance
- Kathleen Ives, OppenheimerFunds
- Satish Lalchand, Deloitte Transactions and Business Analytics LLP
- Christof W. Stahel, Division of Economic and Risk Analysis, SEC
- Christopher Stavrakos, Division of Investment Management, SEC

Take Away:

» "Firms that are able to embed data analytics into their compliance programs are enabling the ability to identify potential issues that may not be readily apparent in traditional testing and monitoring, permitting them to stay ahead of the regulator, as well as protect their investors and reputation."

Ernst & Young (2016)

SESSION 2-C: Running for Cover: Derivatives Investments Under the 1940 Act

Kenneth C. Fang, Moderator
Investment Company Institute

Amy R. Doberman
Wilmer Cutler Pickering Hale and Dorr LLP

Karen L. Skidmore
Franklin Templeton Investments

Danforth Townley
U.S. Securities and Exchange Commission

John M. Zerr
Invesco

Outline of Presentation

- Background
- SEC's rationale for proposed rule 18f-4
- Key elements of the proposal
  - Portfolio limitations
  - Asset segregation
  - Derivatives risk management program
- Next Steps

Application of Section 18 to Derivatives

- Subject to certain exceptions, Section 18 generally restricts a fund's ability to issue "senior securities."
- Senior security is defined as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends."
- Legislative purpose of Section 18 was to "limit increases in the speculative character of junior securities issued by investment companies."

Application of Section 18 to Derivatives

- *Initial Extension to Trading Practices.* Release No. 10666 (1979) extends the definition of "senior security" to certain trading practices that create leverage, specifically: (1) reverse repurchase agreements; (2) firm commitment agreements; (3) standby agreements; and, broadly, **to any other practice that has an analogous effect on a fund's capital structure**.

- *Extension to Derivatives.* Subsequent no-action letters identified the use of certain derivatives (*e.g.*, options, futures) as creating "senior security" obligations governed by Section 18.

"Segregation" Requirements for Covering Derivatives

- Release 10666 provides that if a fund maintains a segregated account of "liquid assets" (*i.e.*, cash, U.S. government securities, or other appropriate high-grade debt obligations) to "cover" the transaction, the transaction should not implicate the Section 18 concerns.

- The segregated account, if properly created and maintained, would limit the risk of loss, limit the speculative character of the fund's shares, and assure the availability of adequate assets to meet the obligation associated with the transaction.

Segregation Requirements, cont'd.

- *Types of Assets Used for Cover.* In Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996), the SEC Staff expanded the universe of liquid assets that may be used for cover to include "any asset, including equity securities and non-investment grade debt, … so long as the asset is liquid and marked-to-market daily."

- *Amount Required to Cover Obligations.* Practices are inconsistent throughout the industry, as Staff positions regarding various instruments have evolved informally through the disclosure process and examination comments, rather than through formal interpretation or the adoption of rules (*e.g.*, basing amount to "cover" cash-settled futures contracts on current market exposure rather than notional value).

Alternative Methods to "Cover" Obligations

- In Dreyfus Strategic Investing, SEC No-Action Letter (June 22, 1987), the Staff provided guidance regarding the ability to use offsetting positions or transactions, instead of asset segregation, as a means of cover and gave examples of offsetting transactions.
  - A fund that has a long position in a futures or forward contract may purchase a put option on the same futures or forward contract with a strike price as high or higher.
  - A fund may cover a written call option by owning the same underlying security.

Role of the Fund Board with Respect to Derivatives

- Release 10666 - Fund boards have a significant role with respect to oversight of certain transactions that raise leverage concerns. Specifically, a board should review the adequacy of the fund's disclosure, valuation, and accounting for such transactions, as well as maintenance of sufficient assets to meet redemption requests and the fund's investment objectives.
- Further, fund boards should pay attention to increases in a fund's use of leverage (and corresponding increases in segregated amounts) because "as asset segregation reaches certain levels, [a fund] may impair its ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with its stated investment objectives."

Report of the Task Force on Investment Company Use of Derivatives and Leverage

Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010)

- The SEC should continue to apply Section 18 only to instruments that create investment leverage, but not economic leverage.

- The SEC should require each fund to adopt, and have its board approve, policies and procedures that:
  - Establish minimum asset segregation requirements for each type of derivative instrument.
  - Specify "Risk-Adjusted Segregated Amounts."
  - State the types of assets to be segregated to cover particular transactions.
  - Identify what constitutes an offsetting transaction.

Use of Derivatives by Investment Companies under the Investment Company Act of 1940 ("Concept Release")

(August 31, 2011)

- Does the definition of leverage in Release 10666 adequately address the risks posed by derivatives intended to be addressed by Section 18?
- Are maximum exposure or leverage limitations more appropriate than asset segregation?
- Requirements for covering derivatives:
  - Restrictions on the types of assets that are segregated to cover?
  - How effectively does segregating daily mark-to-market exposure limit leverage and assure adequate assets are available for cover?
  - Should funds address liquidity and counterparty concerns?
- Do fund boards have the expertise to provide oversight?

Rationale for the Proposed Rule

- Purpose of rule
- Highlights of the proposal
  - Portfolio limitations
  - Asset segregation
  - Derivatives risk management program

Portfolio Limitations for Derivatives Transactions

A fund that engages in derivatives transactions must have its board approve one of the two portfolio limits contained in Rule 18f-4 designed to limit the amount of leverage the fund may obtain:

- Exposure-Based Portfolio Limit (150% of the fund's net assets); or
- Risk-Based Portfolio Limit (300% of the fund's net assets).

The portfolio limits are measured and must be complied with immediately after entering into any derivatives transaction.

Exposure-Based Portfolio Limit

- A fund must limit its senior securities "exposure" resulting from (i) derivatives transactions, (ii) financial commitment transactions and (iii) aggregate indebtedness under Section 18 or 61 of the 1940 Act to 150% or less of the fund's net assets.
  - "Derivative transactions" means any swap, futures contract, forward, option, any combination of the foregoing or similar instrument.
  - "Financial commitment transactions" means any reverse repurchase agreement, short sale or borrowing or any firm commitment or standby agreement or similar agreement.

Calculating Aggregate Notional Exposure

- The "exposure" of a derivatives transaction is generally its notional amount, which is the market value of an equivalent position in the underlying reference asset or principal amount on which payment obligations are calculated.
- The notional amount of a derivatives transaction is required to be adjusted in three narrow circumstances:
  - Derivatives transactions that provide a return on the leveraged performance of the reference asset (requires multiplication of the notional amount by a leverage factor to take into account the leveraged return of the reference asset).
  - Derivatives transactions based upon a reference asset that is a managed account or entity formed or operated primarily for the purpose of investing or trading in derivatives transactions (or index that reflects the performance of such a managed account or entity) (requires look through to the derivative transactions of the reference entity).
  - Complex derivative transactions where payment is dependent upon value of reference asset at multiple points in time or is a non-linear function of the value of the reference asset (rule provides specific calculation methodology).

Netting

- In calculating the aggregate notional exposure of derivative transactions, there is no "netting" or reduction of exposure calculations from hedging or risk-mitigating derivatives transactions.
  - There is a very narrow exception to the no netting requirement for offsetting transactions that are: (i) same type of instrument; (ii) same reference asset; (iii) same maturity; and (iv) same other material terms.
  - Offsetting transactions may be placed through different counterparties.

Risk-Based Portfolio Limit

- As an alternative to the exposure-based portfolio limit of 150% of a fund's net assets, a fund could obtain aggregate exposure of up to 300% of the fund's net assets if it is able to pass a risk-based test based upon value-at-risk ("VaR") methodology:
  - VaR is defined as an estimate of potential losses on an instrument or portfolio expressed as a positive amount in US dollars over a specified time horizon of a given confidence level.
- VaR test: Fund's portfolio VaR (VaR of the entire portfolio including securities, other investments and derivative transactions) must be less than fund's securities VaR (VaR of the fund's portfolio ***excluding*** derivative transactions).

Fund's Portfolio VaR < Fund's Securities VaR

- VaR test is designed to provide an indication of whether a fund's derivative transactions, in aggregate, serve to reduce a fund's market risk.

Rationale for Portfolio Limits

- Why does the SEC think that it needs to impose a limit on the amount of notional exposure a fund takes on?
- Proposing Release, like Release 10666, cites Sections 1(b)(7) and 1(b)(8) of the 1940 Act: "the national public interest and the interest of investors are adversely affected" when funds "by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character" of securities issued to common shareholders and when funds "operate without adequate assets or reserves."
- SEC believes funds' use of derivatives implicate the undue speculation concern expressed in Section 1(b)(7) and the asset sufficiency concern expressed in Section 1(b)(8).

Industry Views on the Shortcomings of Notional Exposure

- Two different derivatives may have the same notional value but very different risk profiles (*e.g.*, two-year treasury future vs. high yield credit default swap with the same notional amount).
- Simply summing the notional value of a fund's derivative instruments may provide a distorted picture of risk. Portfolio managers assess risk at a portfolio level and view derivative exposures on a net basis (*e.g.*, pair trades).
- Both the 150% Exposure-Based Limit and the 300% Risk-Based Limit are arbitrarily selected limits and do not measure risk or prevent a portfolio from becoming "unduly speculative."
- Imposing limits on notional exposure may effectively:
  - limit investor choice of products offering meaningful downside protection; and
  - eliminate certain multi-asset funds, including those with risk reducing strategies, which could push investors into riskier products.

Identical Notional Amounts Can Represent Very Different Risks

- A limitation on a fund's aggregate notional exposure across all derivative instruments will not achieve a uniform standard of limiting risk or volatility or prevent funds from being unduly speculative
- The risk and volatility profile of two different derivative instruments, both with the same notional amount, may be vastly different, as shown below

Future	Gain/Loss from Large Move 100k Contract	%
US Two Year	$ 155	0.2%
US 10 Year	$ 901	0.9%
US Long Bond	$ 1,807	1.8%
US Ultra Long Bond	$ 2,290	2.3%
S&P 500	$ 2,238	2.2%
Russell 2000	$ 2,924	2.9%
Brazilain Equity	$ 4,777	4.8%
Natural Gas	$ 17,770	17.8%
Corn	$ 15,864	15.9%
Crude Oil	$ 16,567	16.6%
Gold	$ 2,734	2.7%
Euro	$ 1,673	1.7%
Australian Dollar	$ 1,882	1.9%
Hungarian Forint	$ 2,088	2.1%

Notional Exposure is Not a Widely Used Portfolio Risk Metric

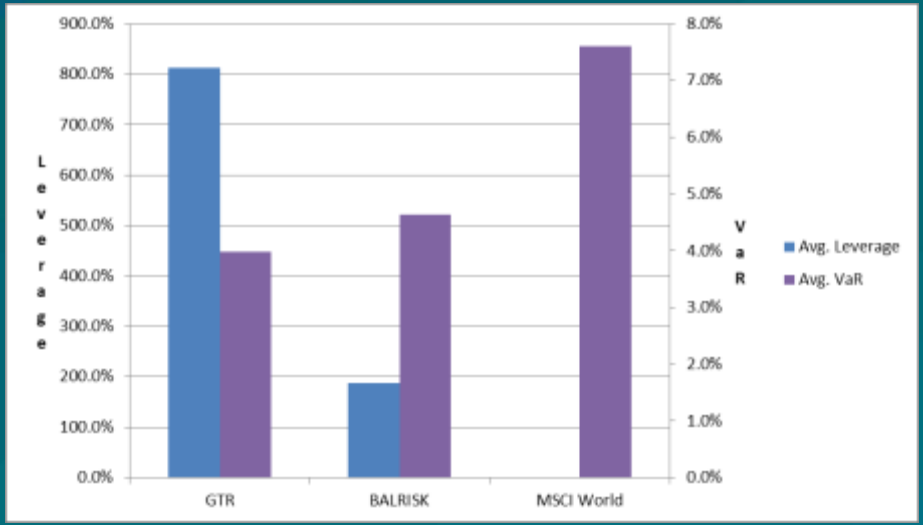
» US and global regulators, as well as global exchanges/clearing houses, have recognized that risk should be analyzed holistically at the portfolio level, not only on an instrument-by-instrument basis, in order to provide an accurate assessment of a portfolio's derivatives-based risk

Organization	Type	Risk Method	Risk Base	Notes
UCITS IV/ AIFMD	European framework for UCITS and AIF's	Principle based, daily VaR monitoring complimented with Stress Testing	Portfolio	▪ European mutual funds (UCITS) and Alternative Investment Funds (AIFs) ▪ Commitment Approach – one option does use notional but allows for reductions.
Basel III	Bank capital ratios	Risk Based Capital/Risk Weighted Assets ("RWA")	Portfolio + RWA	▪ All Major US Banks
LCH Clearnet	OTC Central Clearing	Expected Shortfall Historical Risk simulation	Portfolio	▪ Largest interest rate swap clearing service globally
ICE/ICE Clear Europe	Futures and OTC Clearing	SPAN margining – Includes historical simulation and offsetting trades	Portfolio	▪ Largest European multi-asset clearer
CME Clearing	Futures and OTC Clearing	SPAN margining Includes historical simulation and offsetting trades	Portfolio	▪ Largest central counterparty clearing services in the world ▪ SPAN used by 50 other exchanges
Eurex	Futures	Prisma – Stress Test and Historical Simulation	Portfolio	▪ Largest futures exchange in Europe

Greater Notional Exposure and Leverage Does Not Mean Greater Risk

- **Leverage** is often defined as the ratio of aggregate derivatives exposure to its NAV.
- **Aggregate derivatives exposure** is often calculated as the sum of the absolute value of all of the notional amounts for each derivatives trade.
- An accurate measurement of the fund's **market risk** (defined generally as the risk of loss from adverse changes in market prices) may be determined using a risk based analysis such as VaR – not calculating the aggregate derivatives exposure of the fund.

The following graph shows the VaR and leverage for each of Invesco Global Targeted Returns Fund and Invesco Balanced-Risk Allocation Fund compared to the VaR and leverage for the MSCI World Index:



Portfolio Limits – Other Issues and Potential Alternatives

Asset Segregation – Summary of Proposed Requirements

- ***Qualifying Assets:*** Segregation would be limited to "qualifying coverage assets," generally defined as cash and cash equivalents, designated on a fund's books and records (rather than segregated in a separate custodial account). Liquid assets, such as equity and debt securities could no longer be segregated, except:
  - Assets that satisfy the fund's obligation by delivering a particular asset (such as writing a covered call on a single stock), but not another derivative that provides offsetting exposure.
  - For financial commitment transactions, assets convertible to or generating sufficient cash to pay a fund's obligations (such as a bond's coupon payments or maturity).

Asset Segregation – Summary of Proposed Requirements cont'd.

- ***Required Asset Coverage for Derivatives:*** assets equal to the *sum*, calculated daily for each transaction (whether physical or cash-settled), of:
  - ***Mark-to-market coverage amount:*** the amount the fund would need to pay to close out its derivatives at the time of the calculation (adjusted for netting under a netting agreements and reduced by variation margin posted); *plus*
  - ***Risk-based coverage amount (or "cushion")***: a reasonable estimate of the potential amount the fund would pay to exit the derivatives under "stressed conditions" (reduced by any posted initial margin or collateral).

Asset Segregation – Summary of Proposed Requirements, cont'd.

- Coverage amounts could *not* be offset or reduced by gains on "in the money" derivatives, other than among derivatives subject to a contractual netting arrangement.

- ***Required Asset Coverage for Financial Commitment Transactions:*** assets equal to 100% of its payment or delivery obligations, whether conditional or unconditional.

Asset Segregation – Summary of Proposed Requirements, cont'd.

» ***Role of Fund Board:*** The fund's board, including a majority of disinterested directors, must approve policies and procedures designed to determine the appropriate risk-based coverage amounts for each derivatives transaction and to maintain "qualifying coverage assets" for all financial commitment transactions and derivatives transactions.

Asset Segregation – Issues and Potential Alternatives

Derivatives Risk Management Program

- Would be required for funds that:
  - Exceed a 50% threshold of notional derivatives exposure; or
  - Invest in "complex derivatives" as defined in the proposal.

- Funds must adopt and implement a formalized program reasonably designed to assess and manage risks associated with the fund's derivatives transactions.

Elements of Program

- Derivatives risk manager
  - Fund board must approve an employee or officer of fund or adviser to act as derivative risk manager.
  - Derivatives risk manager cannot be portfolio manager of fund.

- Assessment of risks
  - A program must assess: leverage risk; market risk; counterparty risk; liquidity risk and counterparty risk.

Elements of Program, cont'd.

- Management of risks
  - A fund must manage risks consistent with a fund's investment guidelines, portfolio limitations, disclosure and investment strategy.
- Reasonable segregation of derivatives risk management function and portfolio management function.
- Periodic program review and update (at least annually).

Board Approvals and Oversight

- The Board would be required to:
  - Approve one of two portfolio limits.
  - Approve policies and procedures reasonably designed to provide for required qualifying coverage assets.
  - Approve derivatives risk management program:
    - Initially approve the program and any material changes to it;
    - Approve the designation of a derivatives risk manager; and
    - Review quarterly reports from the derivatives risk manager that address the adequacy of the program and effectiveness of its implementation.

Derivatives Risk Management Program – Issues and Potential Alternatives

What Should Funds be Doing Now?

- Educate your portfolio managers and other relevant persons about the requirements of the proposed rule.
- Assess potential impacts on your funds and their strategies if the proposal is adopted – and don't forget funds in your product pipeline. Ensure that a cross-functional team is doing this analysis and engaged in a dialogue, for example, include folks from portfolio, product management, risk management, legal, compliance, trading, fund accounting, and other operational areas.
- Consider implications to systems and any need for automation or new tools.
- Review your fund disclosure, especially for those funds with heavy derivatives use.
- Communicate implications of the proposed rule to your board.
- Work with ICI and other industry groups to make your concerns known.
- File a comment letter with the SEC.

Conclusion

» Comments are due March 28
» Questions?

Use of Derivatives in Mutual Funds: Current Issues and Regulatory Developments

On December 11, 2015 the Securities and Exchange Commission ("SEC") Proposed Rule 18f-4 under the Investment Company Act of 1940 ("1940 Act"), an exemptive rule that addresses how funds[1] may use derivatives consistent with Section 18 of the 1940 Act.[2] Proposed Rule 18f-4 provides for a new, exclusive means by which funds may enter into derivatives, short sales, or other transactions that create conditional or unconditional future payment obligations on the fund. The proposal follows more than 30 years of incomplete, and sometimes inconsistent, guidance from the SEC and the SEC staff on the subject.

Funds use derivatives as part of their investment program for a variety of reasons, including to "increase leverage to boost returns, gain access to certain markets, achieve greater transaction efficiency and hedge interest rate, credit and other risk."[3] The use of derivatives raises many questions under the 1940 Act. These issues were detailed in July 2010 by the ABA Section of Business Law, in *Report of the Task Force on Investment Company Use of Derivatives and Leverage* (the "ABA Derivatives Report") and subsequently outlined in 2011 by the SEC in the Concept Release. The history and current regulatory issues, including certain issues not addressed by the Proposed Rule, are outlined herein.

I. REGULATION OF DERIVATIVES UNDER SECTION 18

A. Application of Section 18 to Derivatives

i. 1940 Act Prohibition on Issuance of Senior Securities. Section 18 generally restricts a fund's ability to issue "senior securities."

a. *Definition*. Senior security means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority

---

[1] As used herein, the term "fund" refers collectively to open-end investment companies, exchange-traded funds, closed-end funds, and business development companies.

[2] Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933, 80 Fed. Reg. 80884 (December 28, 2015) (the "Proposing Release"). A companion white paper, entitled "Use of Derivatives by Investment Companies", authored by the SEC's Division of Economic Risk Analysis, is available at http://www.sec.gov/dera/staff-papers/whitepapers/derivatives12-2015.pdf

[3] Use of Derivatives by Investment Companies Under the Investment Company Act, Investment Company Act Release No. 29776, 76 Fed. Reg. 55237 (September 7, 2011)(the "Concept Release") at 55238.

over any other class as to distribution of assets or payment of dividends.[4]

b. *Background*. The legislative purpose of Section 18 is to "limit increases in the speculative character of junior securities issued by investment companies."[5]

c. *Exceptions to the Prohibition*. Section 18 provides limited exceptions from its general prohibition on the issuance of senior securities if:

1. with respect to a closed-end fund: (1) the class of senior security represents indebtedness, immediately after the issuance of such security, the fund has asset coverage of at least 300% and the debt securities are subject to certain conditions; and (2) the class of senior security is a stock, immediately after the issuance of such security, the fund has asset coverage of at least 200% and the preferred stock are subject to certain conditions;[6] or

2. with respect to an open-end fund, the fund is borrowing from a bank and immediately after any such borrowing there is asset coverage of at least 300% for all borrowings of such fund and the fund maintains such asset coverage level.[7]

ii. Extension of Section 18. The definition of "senior security" was extended to certain other securities trading practices that create leverage in *Securities Trading Practices of Registered Investment Companies* (Investment Company Act Release No. 10666) (April 18, 1979) ("Release 10666"), and in no-action letters.

a. *Defining Leverage*. Release 10666 describes that "[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed"[8] and in turn "magnifies the potential for gain or loss on monies invested . . .

[4] Section 18(g) of the 1940 Act.
[5] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (April 27, 1979) ("Release 10666").
[6] Section 18(a) of the 1940 Act.
[7] Section 18(f) of the 1940 Act.
[8] Release 10666 at note 5.

result[ing] in an increase in the speculative character of the [fund's] outstanding securities."[9]

b. *Types of Leverage.* The Section 18 prohibition applies to derivatives that create "investment leverage" rather than purely "economic leverage." Investment leverage exists when the instrument can "create obligations, or potential indebtedness . . . [in] an amount that exceeds the fund's initial investment."[10] In contrast, economic leverage exists when the instrument gives exposure to gains in excess of the initial investment but does "not impose a payment obligation on the fund above its initial investment."[11]

c. *Transactions Discussed*. Release 10666 discussed three types of securities transactions that may be deemed to create leverage: (1) reverse repurchase agreements; (2) firm commitment agreements; and (3) standby agreements (collectively, the "Trading Practices").

Release 10666 notes that the Trading Practices are only examples, and if a fund "were to issue a security which affected its capital structure in a manner analogous to the agreements discussed herein, and barring other material differences, the SEC believes it would view that transaction from a similar analytical posture."[12]

d. *Extension to Derivatives.* Subsequent no-action letters treated the use of certain derivatives as analogous to the Trading Practices thus creating "senior security" obligations governed by Section 18.[13]

iii. Key Issue. Should Section 18 be used to regulate derivatives and, if so, which ones?

a. *ABA Derivatives Report Recommendatio*n. The framework under Release 10666 "has worked well [and] will continue to provide an appropriate structure for funds' investments in derivatives."[14] The SEC should continue to distinguish between instruments which

[9] *Id*. at 25129.
[10] Concept Release at 55240.
[11] *Id*. *See also* ABA Derivatives Report at 9.
[12] Release 10666 at 25128.
[13] *See, e.g.*, Emerald Management Co., SEC No-Action Letter (Jan. 21, 1978) (application of Section 18 to the writing of put and call options); Hutton Options Trading L.P., SEC No-Action Letter (February 2, 1989) (application of Section 18 to put and call options strategies); and Dreyfus Strategic Investing, SEC No-Action Letter (June 22, 1987) (application of Section 18 to use of futures contracts).
[14] ABA Derivatives Report at 16.

create investment leverage vs. economic leverage and only apply Section 18 to the former.

b. *Open Questions under the Concept Release*.

1. Do derivatives that create economic leverage but not indebtedness raise the same concerns for investors as those that do create indebtedness?

2. More generally, is the definition of leverage in Release 10666 (*i.e.*, the right to a return on a capital base greater than the initial investment) adequate to address the risks posed by derivatives intended to be addressed by Section 18, or are there other measures of leverage that are sufficiently precise, objective and appropriate?[15]

B. **Requirements for Covering Derivatives Obligations**.

i. The Concept of "Cover." Release 10666 provides that, if a fund engaging in any of the Trading Practices maintains a segregated account of "liquid assets" (*i.e.*, cash, U.S. government securities, or other appropriate high-grade debt obligations) to "cover" the transaction, the transaction should not implicate the provisions of Section 18.[16]

a. *Background*. The purpose of the segregated account is to limit the speculative character of the fund's shares by reducing the fund's risk of loss and assuring the availability of adequate assets to meet the obligation associated with the transaction.[17]

b. *Types of Instruments for Cover*. The universe of assets that may be segregated to cover a transaction was dramatically expanded in Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996) (the "Merrill Letter"). There, the SEC staff indicated that it would be "consistent with the language and policy of Section 18(f) and Release 10666 to permit a [fund] to place any asset, including equity securities and non-investment grade debt, in a segregated account, so long as the asset is liquid and marked-to-market daily"

[15] Concept Release at 55247.

[16] In Dreyfus Strategic Investing, SEC No-Action Letter (June 22, 1987), the staff provided guidance regarding the ability to use offsetting positions or transactions, instead of asset segregation, as a means of cover and gave examples of offsetting transactions.

[17] Release 10666 at 25132.

and additional assets are placed in the segregated account whenever necessary to maintain the amount required.[18]

c. *Amount Required to Cover Obligations*. The process by which funds determine the appropriate amounts to segregate has been somewhat inconsistent throughout the industry. Positions have evolved through the disclosure review process and examination comments, rather than through formal interpretation or the adoption of rules. For example, several funds disclose in their registration statements that the amount of assets they segregate to "cover" cash-settled futures contracts is based on current market exposure rather than notional value. The distinction between cash-settled futures contracts and those settled by delivery has surfaced through the disclosure review process. Similarly, certain funds cover the marked to market obligation associated with total return swaps, while others cover with the full notional amount of the contract. Certain positions, such as those applicable to credit default swaps, evolved through informal comments made by the Staff.[19]

ii. Key Issue. What is the appropriate type and amount of assets to be segregated to cover different derivative transactions, and is segregation the right approach to address concerns applicable to derivatives? Additionally, should cover via offsetting transactions be permitted for derivatives and, if so, are any special limitations or restrictions necessary for its use to effectively address concerns in the context of derivatives?

a. *ABA Derivatives Report Recommendation*. To regulate the type and amount of assets used in segregation, the SEC could require each fund to adopt policies and procedures (the "Derivatives Procedures") that, among other things: (1) establish minimum asset segregation requirements for each type of derivative instrument based on relevant factors such as the type of derivative, the specific transaction, and nature of the segregated assets; (2) state the types of assets to be segregated to cover particular transactions taking into account the type of derivative instrument and amount to be segregated; and (3) identify what constitutes an offsetting transaction by addressing,

[18] *Id*. The SEC staff also stated that "segregated assets" do not need to be physically segregated but rather "[i]t is sufficient, for purposes of [the segregation] requirement, if the [fund's] custodian notes on its books that the assets in question are 'segregated.'" *See* Merrill Letter at 3.

[19] Susan Ervin and Matthew Kluchenek, Possible Breakthrough to Expanded Use of Futures by Investment Companies, Vol. 39 No. 14, *Rev. of Sec. & Commodities Reg*. (Aug. 2006).

among other things, pegged currencies, substantially correlated offsetting positions, and different counterparties.

The SEC should regulate compliance with Section 18 by applying a flexible, principles-based approach. A fund's Derivatives Procedures should be approved by its board and specify "Risk-Adjusted Segregated Amounts" ("RASA") for each derivative used by the fund taking into consideration relevant risk measures such as Value at Risk ("VaR"), potentially subject to SEC guidance of a general nature.[20] The SEC should provide additional guidance for fund boards describing principles upon which board members can analyze the Derivatives Procedures.[21]

b. *Open Questions under the Concept Release*.

1. Should any restrictions be placed on the type of liquid assets that may be segregated to "cover" a given derivative, *e.g.*, to exclude assets that replicate the fund's exposure under the covered obligation?[22]

2. Should asset segregation amounts differ for cash-settled vs. physically settled derivatives?

3. For futures, swaps, and other derivatives with zero market value at inception, how effectively does segregating daily mark-to-market exposure serve the objective of limiting leverage and assuring availability of adequate assets to cover obligations, especially for derivatives with widely fluctuating daily values?

4. Segregation addresses leverage concerns raised by derivatives but may not address liquidity or counterparty concerns or other objectives. Should funds using derivatives be required to address:[23]

[20] ABA Derivatives Report at 17.
[21] *Id*. at 49.
[22] Concept Release at 55248.
[23] *Id*.

i. liquidity concerns by: (a) conducting ongoing analysis of the liquidity of derivatives; and/or (b) taking action when the liquidity of derivatives decline below specified thresholds?

ii. counterparty concerns by: (a) undertaking ongoing credit analysis of derivatives counterparties; (b) maintaining minimum diversification among counterparties; and/or (c) taking action when concentration among, or creditworthiness?

5. Is owning or having the right to obtain assets that a fund obligates itself to deliver an adequate substitute for segregation in order to effectively limit the fund's leverage, risk of loss, and potential inability to satisfy future obligations?[24]

6. Should non-asset segregation cover methods be permitted only for offsetting transactions with the same counterparty to the senior security being covered?[25]

7. Do fund boards have sufficient expertise to oversee an asset segregation approach to leverage and derivative risk management that employs RASA or VaR?[26]

8. If funds are permitted to determine the cover amount for their derivatives investments, should the SEC give guidance concerning minimum requirements for cover amounts or methodologies for determining cover amounts?[27]

C. **Role of the Fund Board with Respect to Derivatives**.

i. Guidance under Release 10666. Release 10666 notes that a fund's board has a significant role with respect to certain oversight of the Trading Practices (or other transactions that raise leverage concerns). Specifically, the board should review the adequacy of the fund's disclosure, valuation, and accounting for Trading Practices, as well as

[24] Concept Release at 55248.
[25] *Id*.
[26] Concept Release at 55248.
[27] *Id*.

maintenance of sufficient assets to meet redemption requests and the fund's investment objectives.

Release 10666 advises fund boards to pay attention to increases in a fund's use of leverage (and corresponding increases in segregated amounts) because "as asset segregation reaches certain levels, [a fund] may impair its ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with its stated investment objectives."

ii. Key Issue. How much discretion should funds be granted in managing derivatives, and what should be the role of the board?

D. Proposed Rule 18f-4 – How were these issues addressed?

i. Scope: Application of Section 18 to Derivatives

a. Proposed Rule 18f-4 would apply to "senior security transactions" which include:

1. *Derivatives Transactions*: Any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument that may require payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination.

2. *Financial Commitment Transactions*: Any short sale, reverse repurchase agreement, firm or standby commitment agreement, or similar agreement (such as a capital commitment to a private fund that can be drawn at its discretion).[28]

3. *Other Senior Security Transactions*: Any other senior security entered into by a fund under Sections 18 or 61 of the 1940 Act, including borrowings from banks under the 300% asset coverage test and, in the case of closed-end funds and BDCs, issuance of debt or preferred stock.

b. Proposed Rule 18f-4 would not affect the ability of a fund to enter into transactions providing indirect or "economic" leverage, such as purchased options, because these transactions do not create a

[28] Proposing Release at 80899-80900. As proposed, securities lending transactions would not be included within the definition of "financial commitment transaction."

potential payment obligation and therefore are not considered to involve the issuance of senior securities.

ii. Segregation Requirements for Covering Derivatives.

a. *Qualifying Coverage Assets*. Qualifying coverage assets for derivatives would be limited to *cash and cash equivalents* subject to one limited exception for derivatives transactions that contractually permit a fund to satisfy its obligation by delivering a particular asset.[29] For these transactions, the underlying asset may be segregated as the qualifying coverage asset.[30]

1. The minimum amount that a fund must segregate for *both* physical and cash-settled derivative transactions, would equal the sum of: (1) the fund's mark-to-market exposure on the derivatives transaction, reduced by any variation margin or collateral; and (2) a reasonable estimate of the potential amount the fund would be required to pay to exit the derivatives transaction under stressed conditions, reduced by any initial margin posted by the fund (the "risk-based coverage amount").

2. The calculation would be performed separately for: (1) each portion of the coverage amount (*i.e.*, the mark-to-market coverage amount is calculated independently of the risk-based coverage amount) and (2) each derivatives transaction.[31]

b. *Portfolio Limits*. Adequate coverage assets would no longer be sufficient to address Section 18 compliance. In addition to the asset segregation requirements, Proposed Rule 18f-4 also would require compliance with one of two new aggregate portfolio limitation

[29] Qualifying coverage assets may still be designated or "segregated" on a fund's books and records (rather than segregated in a separate custodial account or on the custodian's books).

[30] Proposing Release at 80948. In addition to these two types of qualifying coverage assets, financial commitment transactions could use a third type when the timing of the fund's payment obligation can be reasonably estimated, in which case a fund would be able to segregate assets other than cash and cash equivalents if such assets are convertible to or generate sufficient cash before the date on which the fund is required to pay its obligation.

[31] For example, a derivatives transaction that is "in-the-money" with unrealized gains would have a mark-to-market coverage amount of $0 (as opposed to a negative amount), and neither the risk-based coverage amount for that derivatives transaction, nor any coverage amount for another derivatives transaction, could be netted or reduced by such gains. The only exception would permit such reduction of coverage amounts among derivatives transactions subject to a contractual netting arrangement.

requirements: an exposure based portfolio limit or risk-based portfolio limit.

1. *Exposure-based Portfolio Limit.* Senior securities exposure, including exposure from derivatives, may not exceed 150% of net assets.

2. *Risk-based Portfolio Limit*. Senior securities exposure, including exposure from derivatives, may not exceed 300% of net assets and the fund must satisfy a value-at-risk ("VaR") test designed to demonstrate that the VaR of the fund's portfolio *with* derivatives transactions is less than *without* derivatives transactions.[32] Proposed Rule 18f-4 would define VaR as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level."[33]

   i. The applicable limit would need to be satisfied immediately after entering into each derivatives transaction or financial commitment transaction.

   ii. "Exposure" would be defined as the sum of: (1) the aggregate notional value of a fund's derivatives transactions;[34] (2) the aggregate obligations of the fund under its financial commitment transactions; and (3) the aggregate indebtedness (and as to any closed-end fund or BDC, involuntary liquidation preference) under any other senior securities entered into by the fund under Sections 18 or 61.

c. *No Provision for Offsetting Transactions*. Non-asset segregation cover methods are generally *not* permitted (i.e. a fund may not reduce the amount of qualifying coverage assets to be segregated by entering into an offsetting transaction) <u>and</u> a fund may not reduce its "exposure" by entering into derivative transactions that merely

[32] A fund using the risk-based portfolio limit would have discretion to select a VaR model, if it incorporates all significant identifiable market risk factors associated with a fund's investments and applies a minimum 99% confidence interval, a time horizon of between 10 and 20 trading days, and a minimum of three years of historical data to estimate historical VaR. Proposing Release at 80920.

[33] Proposed Rule 18f-4(c)(11).

[34] *See* Proposing Release at 80902 for a table of common derivatives transactions and the method by which the SEC understands notional value is typically calculated for each.

hedge or provide offsetting exposure without closing out the existing position.[35]

iii. Role of the Fund Board with Respect to Derivatives.

a. Each fund entering into *derivatives* transactions in reliance on Rule 18f-4 also would be required to either: (1) monitor that the fund engages in no complex derivatives transactions[36] and only a limited amount of derivatives transactions (generally defined as derivatives transactions with notional exposure not to exceed 50% of net assets) or (2) adopt a formalized derivatives risk management program with a designated derivatives risk manager independent from the fund's portfolio managers. If required to have a derivatives risk management program:

b. The fund's board, including a majority of its independent directors, would need to approve:

1. The derivatives risk management program, any material changes to the program, and the designated risk manager who would be required to administer the program.[37]

i. The program must be governed by policies and procedures reasonably designed to: (1) assess the risks associated with the fund's derivatives transactions, including an evaluation of applicable potential leverage, market, counterparty, liquidity, operational risks, and any other risks considered relevant; (2) manage the risks of the fund's derivatives transactions, including by monitoring the fund's use of derivatives transactions and informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions; (3) reasonably segregate the functions associated with the program from the portfolio

[35] *Id.* at 80906.

[36] Rule 18f-4 would define "complex derivatives transaction" as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (i) depends on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price (which is typical of all standard put and call options).

[37] Proposing Release at 80935. The fund's board, including a majority of its independent directors, would also be required to review at least quarterly, a report by the fund's designated risk manager that describes the adequacy of the program and the effectiveness of its implementation. *See* Proposed Rule 18f-4(a)(3)(ii)(B).

management of the fund; and (4) periodically (and at least annually) review and update the program.[38]

2. Policies and procedures designed to determine the appropriate "risk-based coverage amounts" for each derivatives transaction and to maintain qualifying coverage assets for all financial commitment transactions and derivatives transactions.[39]

3. One of the two alternative portfolio limits on the fund's senior securities transactions.

II. OTHER REGULATORY REQUIREMENTS REQUIRING CLARIFICATION

The use of derivatives raises questions under several provisions of the 1940 Act that were discussed in the ABA Derivatives Report and Concept Release but were not addressed by Proposed Rule 18f-4.

A. **Application of Section 12(d)(3) to Derivatives**.

i. 1940 Act Securities-Related Issuer Limit. Funds may not purchase or otherwise acquire any security issued by, or any other interest in the business of, a broker, dealer, underwriter or investment adviser ("securities-related issuers").

a. *Background*. The SEC has taken the position that Section 12(d)(3) was principally designed to protect against the entrepreneurial risks of securities-related issuers and to prevent conflicts of interest and reciprocal practices between funds and companies that are engaged in a securities-related business.[40]

ii. Rule 12d3-1 Exemptions. A fund may acquire securities issued by any "person" that derived 15% or less of its gross revenues from securities-related activities unless the fund would control such person after the acquisition.

---

[38] *Id.* at 80935.

[39] *Id.* at 80926. Independent directors are directors who are not "interested persons" of the fund as defined in Section 2(a)(19) of the 1940 Act. The SEC believes that requiring board approval would "appropriately focus the board's attention on the fund's management of its obligations under derivatives transactions and the fund's use of the exemption provided by the proposed rule." *See also* ABA Derivatives Report at 18 (recommending that a fund's policies and procedures on asset segregation be approved by the fund's board).

[40] Concept Release at 55252, 55253.

Additionally, a fund may acquire any security issued by any person that, in its most recent fiscal year, derived more than 15 percent of its gross revenues from securities-related activities, provided that: (1) immediately after the acquisition of any equity security, the fund owns not more than five percent of the outstanding securities of that class of the issuer's equity securities; (2) immediately after the acquisition of any debt security, the fund owns not more than 10 percent of the outstanding principal amount of the issuer's debt securities; and (3) immediately after any acquisition, the fund has invested not more than five percent of the value of its total assets in the securities of the issuer.

iii. Key Issue. Should Section 12(d)(3) be used to regulate a fund's exposure to: (1) the issuer of the derivative (*i.e.*, counterparty); (2) the issuer of the underlying reference asset; and/or (3) issuers who are not "securities-related issuers?"

a. *ABA Derivatives Report Recommendation*. Section 12(d)(3) provides "an appropriate framework for dealing with fund counterparty exposures [since] counterparties to the derivative instruments that funds use generally fall within the list of securities-related issuers that Section 12(d)(3) applies to" and unlike the diversification requirements, Section 12(d)(3) governs non-diversified as well as diversified funds.[41] However, the SEC should adopt a new rule that separately deals with: (1) investments intended to gain exposure to a securities-related issuer (*e.g.*, where the issuer of the reference asset is a securities-related issuer); and (2) credit risk associated with derivatives counterparties who are securities-related issuers.

b. *Open Questions under the Concept Release*.

1. What is the appropriate regulatory framework for addressing concerns related to a fund's exposure to counterparties that are not securities-related issuers?

2. Should Section 12(d)(3) be applied only to the issuer of the derivative *(i.e.*, the counterparty), with another rule adopted to

[41] *Id*. *See infra*, Section II.B.i (discussing fund diversification requirements).

regulate the issuer of the reference asset? If so, how should those rules differ and why?[42]

3. Is Rule 12d3-1 the appropriate framework for exempting derivatives transactions from Section 12(d)(3)? If so, should a derivative be treated as a debt or equity security (and subject to the 10% vs. 5% limitation, respectively), or is a unique percentage limitation needed for derivatives? What, if any, additional limitations or conditions should be applied to the exemption set forth in Rule 12d3-1 when used for derivatives?[43]

4. Should the extent to which the securities-related issuer posts collateral and secures its obligations to the fund affect the analysis of whether Section 12(d)(3) is implicated by the transaction?[44]

B. <u>Application of Sections 5(b) and 8(b)(1) to Derivatives</u>.

i. <u>1940 Act Diversification Requirement</u>. Section 8(b)(1) requires each fund to describe in its registration statement whether it is classified as diversified or non-diversified as defined in Section 5(b).[45]

a. *Key Definitions*. "Diversified company" means a fund for which at least 75% of the value of its total (*i.e.*, gross) assets is represented by cash and cash items (including receivables), government securities, securities of other investment companies, and other securities which, for the purposes of this calculation, are limited in respect of any one issuer to an amount not greater than 5% of the total assets of such fund and not more than 10% of the outstanding voting securities of such issuer.

A "non-diversified company" is any fund other than a diversified company.

[42] Concept Release at 55253. For example, how are the purposes of Section 12(d)(3) implicated differently by a fund's exposure to: (1) a securities-related counterparty; or (2) price movements and performance of a reference security issued by a securities-related issuer?
[43] *Id*. at 55253.
[44] *Id*.
[45] Section 8(b)(1)(A) of the 1940 Act.

"Issuer" is defined as "every person who issues or proposes to issue any security, or has outstanding any security which it has issued," unless the context otherwise requires.[46]

b. *Background*. The purpose of the diversification requirements is to prevent a fund that holds itself out as diversified from being too closely tied to the success of one or a few issuers or controlling portfolio companies.[47]

ii. 1940 Act Concentration Policy Requirement. Section 8(b)(1) requires each fund to declare in its registration statement a policy concerning whether and, if so, how it concentrates its investments in the securities of issuers within a particular industry.[48]

a. *Key Definition*. The SEC has stated generally that a fund is concentrated in a particular industry or group of industries if the fund invests or proposes to invest more than 25% of the value of its net assets in a particular industry or group of industries.[49]

b. *Background*. The SEC has indicated that the requirement to disclose a concentration policy "reflects the view that such a policy is likely to be central to a fund's ability to achieve its investment objectives, and that a fund that concentrates its investments will be subject to greater risks than funds that do not follow the policy."[50]

iii. Key Issue. Should Sections 5(b) and 8(b)(1) be used to regulate a fund's exposure to (1) of the issuer of the underlying reference asset; or (2) the issuer of the derivative contract (*i.e.*, the counterparty)?

a. *ABA Derivatives Report Recommendation*. The regulation of counterparties and reference securities should be bifurcated to achieve diversification and concentration in a manner consistent with the purposes of the statute and the regulatory concerns of the SEC as follows:[51]

[46] Section 2(a)(22) of the 1940 Act.
[47] Concept Release at 55250.
[48] Section 8(b)(1)(E) of the 1940 Act.
[49] *See*, *e.g.*, Instruction 4 of Item 9 of Form N-1A.
[50] Concept Release at 55252.
[51] 2010 ABA Derivatives Report at 27.

1. Diversification and concentration requirements should be measured by looking only at the reference security and disregarding the counterparty.[52]

2. Counterparty risk should be addressed under Section 12(d)(3) which provides a more comprehensive mechanism for dealing with such concerns.

3. Derivatives that are not securities (*e.g.*, futures on broad-based security market indices) should not be included in the diversification calculation.

b. *Open Questions under the Concept Release.*

1. Should counterparty exposures be addressed under Section 12(d)(3) rather than Sections 5(b) and 8(b)(1)?[53] If yes, should counterparties who are not securities-related issuers (and, therefore, not currently regulated under Section 12(d)(3)) be addressed as part of the diversification and concentration requirements, or added to Section 12(d)(3)?

2. Should other diversification or concentration measures be developed to address derivative exposures?[54]

C. <u>Valuation of Derivatives</u>.

i. <u>Value Definition</u>. Generally, funds must value derivatives and all other assets using market values and fair values, at the end of the fund's last preceding fiscal quarter, or, if subsequently acquired, their cost (in each case, unless the context requires otherwise). Exchange-traded derivatives are generally measured using a "market value" and OTC derivatives are generally measured using "fair value." In either case, the result is that the value "would appear to be the value at which the derivative could be sold or otherwise transferred at the relevant time" (*i.e*. liquidation value).[55]

[52] The ABA Derivatives Report also recommended following this approach with respect to calculating compliance with Rule 35d-1 for funds who are required to comply with the "name rule." See ABA Derivatives Report at 39.
[53] Concept Release at 55251.
[54] *Id*.
[55] *Id*. at 55250. *See also* Section 2(a)(41)(B) of the 1940 Act (stating definition of "Value").

By its terms, measuring the value of derivatives based on liquidation value for the purposes of the diversification requirements and concentration limits could permit a fund to maintain an ongoing exposure that does "not reflect the asset base on which future gains and losses will be based or otherwise represent the potential future exposure of the fund under the derivatives investment."[56]

ii. Key Issue. For purposes of applying Sections 5(b), 8(b)(1) and 12(d)(3), should derivatives be valued using market value (*i.e.*, liquidation value) or notional value?

a. *The 2010 ABA Derivatives Report Recommendation*. Market values (or fair values) are the relevant measure and the one contemplated by the 1940 Act for valuing derivative instruments.[57]

b. *Open Questions Under the Concept Release*.

1. When is mark-to-market value an appropriate measure of a fund's exposure to a particular issuer in light of the purpose of the diversification requirements and concentration limits?[58]

2. If using mark-to-market values, should diversification and concentration be qualified or otherwise supplemented with information regarding the fund's notional exposures of its derivative positions?[59]

3. If using mark-to-market values, how do we value derivatives when there is a negative market value for a derivative instrument (*i.e.*, when the fund owes money to its counterparty in connection with the position)?[60]

4. How do we value derivatives for which: (i) market quotes are not readily available (*e.g.*, certain OTC derivatives); or (ii)

[56] Concept Release at 55250.

[57] 2010 ABA Derivatives Report at 28, 30, 36. The ABA Derivatives Report also recommended following this approach with respect to calculating compliance with Rule 35d-1 for funds who are required to comply with the "name rule." See ABA Derivatives Report at 39.

[58] Concept Release at 55251. While the Concept Release only posed this question in the context of diversification requirements, the ABA Derivatives Report indicates that the calculation of concentration limits involves a similar analysis. ABA Derivatives Report at 30.

[59] *Id*.

[60] *Id*. at 55255. See also 2010 ABA Derivatives Report at 28.

contractual restrictions limit a fund's ability to close out contracts or enter offsetting transactions?[61]

5. What issues should be addressed by any SEC guidance on fair valuation of derivatives?[62]

[61] Concept Release at 55255.
[62] *Id*.

SESSION 2-D: Rules of Engagement: Funds' Interaction with Their Portfolio Companies

Matthew Thornton, Moderator
Investment Company Institute

Donna F. Anderson
T. Rowe Price Associates, Inc.

Peggy Foran
Prudential Financial

Holly J. Gregory
Sidley Austin LLP

Zachary M. Oleksiuk
BlackRock, Inc.

Summary of Topics

- Engagement from Shareholders' Perspective
- Engagement from Issuers' Perspective
- Legal Considerations
- Potential Impediments to Engagement
- Particulars of an Engagement
- Good Practices/Practical Tips
- Long-Term Trends/Predictions

Engagement from Shareholders' Perspective

- Benefits:
  - Broader scope, more nuanced than proxy voting
  - Opportunity to influence governance and enhance shareholder value
  - Fosters better understanding of issuers' thinking and long-term objectives, allowing for more informed evaluation
- Process Considerations:
  - Areas of focus
  - Evaluation of portfolio companies and prioritization
  - Setting objectives

Engagement from Issuers' Perspective

- Benefits:
  - Communicate directly and gain support for board, management, and particular initiatives (*e.g.*, proxy items)
  - Consideration of outside views/perceptions can lead to improvements
  - Strengthen relationships for long-term benefit
- Process considerations:
  - Evaluation of shareholders and prioritization (shareholders are not monolithic)
  - Setting objectives
  - Involvement of management and/or directors

Legal Considerations

- Compliance with Regulation FD (Selective Disclosure Rule)
- Compliance with insider trading and tipping prohibitions
- Protection of confidential information
- Avoidance of group formation and related SEC disclosure
- Antitrust considerations
- Use of agreements/term sheets to guide particular engagements

Potential Impediments to Engagement

- Legal/compliance concerns (manageable: see prior slide)
- Resource limitations (time, personnel)
- Providing inconsistent messages
- General reluctance/inexperience

Particulars of an Engagement

- Method of engagement (*e.g.*, in-person, calls, letters, email)
- Points of contact (*e.g.*, investor relations, corporate secretary, general counsel)
- Setting an agenda/terms for engagement (*e.g.*, topics, participants)
- Length of engagement (ongoing vs. episodic)
- Solo vs. coordination with other shareholders

Good Practices/Practical Tips

- Consider adopting an overall policy/process to guide whether, how, with whom to engage
- Engage in situations other than crises
- Continuously evaluate what works

Long-Term Trends/Predictions

SIDLEY AUSTIN LLP
SIDLEY

OUTLINE OF KEY LEGAL CONSIDERATIONS IN SHAREHOLDER-COMPANY ENGAGEMENT

Since the advent of the mandated shareholder vote on executive compensation ("say-on-pay") in 2011, engagement efforts between shareholders and corporations have increased exponentially. Corporations seek engagement to better understand the concerns of key shareholders about particular issues, and to explain board decisions and corporate positions. Corporate engagement efforts may be motivated by an interest in convincing shareholders to provide support for management on say-on-pay or on a shareholder activism issue, but increasingly corporations are undertaking engagement efforts on a regular basis to help strengthen relations with key shareholders and to foster a better understanding of how shareholders view the company. Similarly, large institutional shareholders may seek engagement with portfolio companies to explain their point of view or to learn more about the drivers of corporate decisions.

Engagement has proven to be an effective tool for releasing tensions between shareholders and corporations and for improving understanding of shareholder concerns and of how management and the board approach long-term strategy and corporate decisions. Companies and shareholders should adopt a thoughtful approach to engagement, to ensure that communications are constructive and meaningful, and do not overload participants.

In addition to the practical considerations of how to focus limited engagement resources, in what circumstances to engage, on what topics and with whom, companies and shareholders should bear in mind the following legal considerations when engaging with one another.

Legal Considerations

1. Fair Disclosure - Regulation FD

- Engagement efforts between companies and shareholders should be designed to comply with Regulation FD. Regulation FD prohibits selective disclosure of material nonpublic information and was adopted by the Securities and Exchange Commission to level the playing field for individual investors.
    - Regulation FD provides that when a company, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and shareholders who may trade on the basis of the information), it must make public disclosure of that information.
    - Regulation FD does not apply to disclosures made to a person who expressly agrees to maintain the disclosed information in confidence (for example, pursuant to a confidentiality agreement).
- The timing of the required public disclosure depends on whether the selective disclosure was intentional or non-intentional.

- If the selective disclosure was intentional, then the company must make the public disclosure *simultaneously*. To this end, it is advisable that the company provide the public disclosure prior to the selective disclosure in order to avoid potential liabilities.

- If the selective disclosure was unintentional, then the company must make public disclosure *promptly*, which means as soon as practicable but in no event later than 24 hours thereafter or the commencement of the next day's trading on its stock exchange, whichever is later.

- Under Regulation FD, the required public disclosure may be made by filing or furnishing a Form 8-K, or by another method or combination of methods that is reasonably designed to effect broad, non-exclusionary distribution of the information to the public such as a press release. The SEC staff has also indicated that, in certain situations, the required level of disclosure can be achieved through the use of a website posting. Companies generally rely on Form 8-Ks and press releases to disclose material information, and may supplement these methods with corporate blogs and postings on social media channels.

2. Insider Trading Liability and Misuse of Nonpublic Information including Investment Advisers Act Section 204A and Rule 204A-1

- When engaging with companies, shareholders may gain access to material information about the company that has not been publicly disseminated. Federal and state securities laws prohibit any purchase or sale of securities on the basis of material nonpublic information, or where it was obtained under circumstances contemplating that it would not be used for personal gain, and in certain other circumstances. In addition, "tipping" of others about such information is prohibited. Shareholders who receive material information from a company during engagement efforts should exercise caution; before trading or otherwise acting on such information, shareholders should confirm that the information has been publicly disclosed.

  - Similar considerations apply when portfolio company officers and directors who engage with a shareholder that is itself publicly traded gain access to material nonpublic information about that shareholder.

- Section 204A of the Investment Advisers Act requires each SEC registered investment adviser to establish, maintain and enforce written policies and procedures, reasonably designed to prevent the misuse of material nonpublic information by such investment adviser or any person associated with such investment adviser. The SEC has clarified that this would encompass the misuse of material nonpublic information about client recommendations, trading and holdings. An adviser's duty of care also requires it to safeguard such sensitive information.

  - Rule 204A-1 under the Investment Advisers Act requires each SEC-registered investment adviser to establish, maintain and enforce a written code of ethics. Though not required to do so, many advisers integrate their required procedures under Section 204A into their codes of ethics, often including a summary of insider trading law and procedures for determining whether information is material and when it has become public.

3. **Confidential Information**

- Improper disclosure of confidential information raises issues of misuse of company property and breach of fiduciary obligations by officers and/or directors, as well as concerns about violations of laws and regulations that prohibit selective disclosure of material nonpublic information and insider trading and tipping (as discussed above). Disclosing confidential information can violate fiduciary duties regardless of whether the person obtains a personal pecuniary interest or other benefit.

4. **Conflicts of Interest**

- Pursuant to law and, in many cases, company and shareholder policies and procedures, officers and directors must act in the best interests of the company and avoid self-dealing and conflicts of interest.

5. **Proxy Solicitation Rules – Exchange Act Rules 14a-6 and 14a-12**

- The proxy solicitation rules only permit discussions with shareholders and other attempts to influence the vote of shareholders based on what has been disclosed in filed proxy soliciting material. Exchange Act Rules 14a-6 and 14a-12 require that all written solicitation materials be filed with the SEC on the date of first use. Depending on the circumstances, scripts, Q&A sheets or similar written materials used during shareholder engagement may need to be filed by the company if they are distributed publicly or designed for repeated use.

6. **Anti-Fraud Rules – Exchange Act Rule 14a-9**

- Exchange Act Rule 14a-9 prohibits making false and misleading statements of material fact in connection with any solicitation of proxies subject to Regulation 14A. A private right of action exists to remedy violations of Rule 14a-9 and scienter is not a required element.

7. **Antitrust Laws**

- Shareholder engagement efforts should be designed to comply with antitrust laws, which seek to prohibit anticompetitive behavior and unfair business practices while encouraging competition in the marketplace.

8. **Exchange Act Section 13(d) Filing Requirements and Group Formation**

- Exchange Act Rule 13d-1 requires investors (or a group of investors) to file a Schedule 13D or 13G within 10 days of acquiring beneficial ownership of more than 5% of a class of voting securities registered under the Exchange Act. If investors are operating as a "group" with respect to their investment in the company's stock, they will each be required to file the applicable report when their collective ownership exceeds the 5%

threshold. Institutional investors may be deemed to have formed a "group" under Section 13(d) of the Exchange Act if they engage in coordinated activity with respect to investment in a company. In addition to an express agreement between investors to act as a group, the following conduct may suggest group activity: (i) direct communications among the institutional investors relating to their investment in the company or a shared goal or plan involving the company, (ii) the provision of funds or advice among investors or (iii) or any pattern of parallel actions by investors within the same time period.

Recommendations

When engaging with one another, companies and shareholders should agree on "rules of engagement" and adhere to the following recommendations that are designed to minimize any risk of violation of law or regulation.

1. Participants

- It is advisable for companies and shareholders to limit the group of individuals authorized to participate in engagement efforts. As management has the principal responsibility for shareholder communications and engagement, these people are typically senior officers. In certain circumstances, it may be appropriate to have one or more directors engage directly with key shareholders. For example, the compensation committee chair should participate if shareholders wish to discuss executive compensation matters. Shareholders should also select appropriate participants, which may depend on the issues proposed to be discussed (for example, on the governance/proxy voting side or the investment side). Members of management and directors who participate in engagement efforts should report to the board of directors and/or appropriate board committee on their discussions.

2. Involvement of Counsel

- Counsel should be involved in preparing for engagement efforts. All company spokespersons and shareholder participants should be briefed on their obligations under Regulation FD and other applicable laws and regulations. It is often prudent to have company counsel participate in meetings with shareholders to reduce the risk of Regulation FD violations and, where needed, to facilitate prompt disclosure if material nonpublic information is inadvertently communicated. If counsel does not attend engagement discussions it is imperative that someone else on the engagement team be tasked with attending to the legal risks that such discussions may implicate.

3. Discussion Topics

- The parties should agree in advance on the topics proposed to be discussed at the meeting. Generally during engagement with shareholders matters should be discussed at a high-level, without a detailed discussion of matters involving the company's strategy, operations or financial condition. Directors who participate in engagement efforts should be encouraged to focus on listening and only speak with respect to topics that have been agreed in advance and on which they are prepared to reflect the company's position as

already disclosed. This is especially important with respect to discussions of strategy, business and financial matters.

- When engaging with portfolio companies, investment advisers should not discuss information about the adviser's securities recommendations or client securities holdings and transactions.

- Company spokespersons should not discuss with shareholders competitive information, customer-specific information or details about the company's pricing, production capacity or market share.

4. Confidentiality

- Any engagement discussion should begin with a brief reminder about the imperative to avoid any exchange of information that could violate laws or regulations, and any subsequent use of confidential information if any is exchanged. Confidential information should not be disclosed by portfolio companies or shareholders when participating in engagement efforts, except with authorization and pursuant to a confidentiality agreement.

5. Conflicts of Interest

- Officers and directors who participate in engagement efforts should ensure that they do so with due care and in the best interests of the company. Engagement between companies and shareholders should be conducted in such a way as to not give rise to actual, apparent or potential conflicts of interest. For example, the offer and acceptance of gifts, entertainment or other benefits should be in accordance with law and applicable company and shareholder policies and procedures.

SESSION 3-A: Cybersecurity: An Exercise in Asymmetric Warfare

Peter G. Salmon, Moderator
Investment Company Institute

Alex Cunningham
State Street Global Advisors

Matthew McNamara
Eaton Vance Management

Richard H. Walzer
Putnam Investments

ICI INITIATIVES

- Chief Information Security Officer Advisory Committee
- Cybersecurity Survey
- Cybersecurity Forum
- Cyber Blog
- Resource Center - https://www.ici.org/info_security
- Member Engagement - U.S., Europe, Asia
- International Organization of Securities Commissions
- Other Non-ICI Conferences

OUR RELATIONSHIP WITH TECHNOLOGY

Trends & Statistics

Ransomware:

- 25 Years Old
- 62% of all malware targeting the U.S.
- CryptoWall - $325 million in 2015
- Many, many more: Accdfisa, Androidos_locker, Cribit, Crilock, Critolock, Crypaura, Crypctb, Crydef, Cryptcoin, Cryptfile, Cryptwall, Cryptrolf, Crypttor, Cryptor, Downcrypt, Virlock, PGPcoder, Kollah, Kouter, Ransom, Reveton, Vbuzky, Cryptop, Gulcrypt, etc.

Business Email Compromise

Cost $1.2 billion over two years
Contact by email or telephone
Scam reported in 79 countries
Funds sent to 72 countries – largest amounts to Hong Kong & China
Able to sidestep basic security
Social media reconnaissance

SESSION 3-B: Accounting and Auditing Update

Brian Wixted, Moderator
OppenheimerFunds

Jaime Eichen
Ernst & Young LLP

Matt Giordano
U.S. Securities and Exchange Commission

Steve Sadoski
Natixis Global Asset Management

Agenda

- Introduction
- Public Company Accounting Oversight Board (PCAOB) – Auditing Standard (AS) 18 – Related Parties
- Reorganization – PCAOB Auditing Standards and Amendments to Auditing Standards and Rules
- Concept Release – Revisions to Audit Committee Disclosures
- Investment Company Reporting Modernization Proposed Rule – REG S-X
- Liquidity Management Program Rulemaking
- Swing Pricing: Financial & Performance Reporting Aspects
- Disclosure Effectiveness Project
- Level 3 Fair Value Measurement Disclosures
- Materiality Proposal/Financial Statement Notes
- Transparency Disclosure of engagement partner and certain participants in the Audits
- Auditing Accounting Estimates & Fair Value Measurements
- Auditor's use of Specialists'

Agenda (Cont.)

- Audit Quality Indicators
- Auditor's Reporting Model
- Securities and Exchange Commission (SEC) Office of Compliance, Inspections & Enforcement (OCIE) Update
- Business Interruption
- Financial Statement Comments
- Foreign Tax Reclaims Refunds
- Accounting & Valuation – Deferred Tax Asset (DTA)
  - Master Limited Partnership Funds
- Derivatives – Custom Baskets/Indexes Disclosure
- Q & A

PCAOB Agenda & Update

- Recently effective PCAOB standard
  - Auditing Standard No. 18, Related Parties
- Recently finalized standard setting projects
  - Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Auditing Standards and Rules
  - Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards
- PCAOB standard setting agenda
  - Planning and Supervision of Audits Involving Other Auditors
  - Going Concern
  - Auditor's Reporting Model
  - Auditing Accounting Estimates, Including Fair Value Measurements and Related Disclosures
  - The Auditor's Use of the Work of Specialists
  - Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities
  - Confirmation
  - PCAOB Standard-Setting Agenda

PCAOB Auditing Standard No. 18 – Related Parties

- Effective for audits of financial statements for fiscal years beginning on or after December 15, 2014, including reviews of interim financial statements within these fiscal years
- Intended to increase the auditor's focus on areas historically associated with risks of error or fraud
- The new standards and amendments require a number of specific procedures focused on related party relationships and transactions, significant unusual transactions and understanding a company's transactions and financial relationships with its executive officers:
  - Understanding a company's process for identifying related-party relationships and transactions, authorizing and approving them and accounting for and disclosing them (typically performed as part of a walk-through)
  - Performing procedures to identify and evaluate the business purpose of significant unusual transactions
  - Obtaining a complete list of related parties and related party transactions
  - Performing inquires of various parties, including management, and others within the company and the audit committee
  - Communicating information regarding related parties within the audit team and with other participants in the audit

PCAOB Auditing Standard No. 18 – Related Parties

- To evaluate the completeness and accuracy of the related-party list, an auditor should:
  - Read minutes of shareholders' and directors' meetings
  - Test journal entries
  - Consider other information gathered during the audit
- If undisclosed related-party relationships are identified, an auditor must perform additional procedures
- Additional matters are required to be communicated to the audit committee with respect to related-party relationships and transactions
- Related amendments:
  - Additional representations from management
  - Significant unusual transactions
  - Financial relationships and transactions with executives

Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Auditing Standards and Rules

- PCAOB adopted amendments to reorganize its auditing standards
  - Intended to present the standards in a logical order that generally follows the flow of the audit process
- Reorganized by topic with a single numbering system and grouped into the following categories:
  - General auditing standards
  - Audit procedures
  - Auditor reporting
  - Matters relating to filings under federal securities laws
  - Other matters associated with audits
- Auditing standards as reorganized
  - PCAOB Reorganized Standards
- Effective as of December 31, 2016
  - Auditors may begin to use and reference the reorganized PCAOB auditing standards prior to December 31, 2016

PCAOB Standard Setting Agenda – December 31, 2015

Recent Development		
Project	**Action**	**Summary**
1. Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards	Adopted by PCAOB on December 15, 2015, subject to SEC approval.	The rules will require disclosure of the name of the engagement partner and information about other accounting firms on new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants.* If approved by the SEC, the new rules and amendments will take effect on a phased basis. Those relating to the engagement partner will be effective for auditors' reports issued on or after January 31, 2017, or three months after the SEC approval of the final rules, whichever is later, while those relating to other accounting firms will be effective for auditors' reports issued on or after June 30, 2017.
January 2016 to June 2016		
Project	**Planned Action Under Consideration**	**Summary**
2. Planning and Supervision of Audits Involving Other Auditors	Proposal	The proposal is expected to include amendments to improve auditing standards that govern the planning and supervision of audits involving other auditors.
3. Going Concern	Staff Consultation Paper	The staff is currently evaluating potential revisions to the existing PCAOB standard on the auditor's going concern evaluation in light of changes to the relevant accounting requirements. The staff anticipates that it will issue a staff consultation paper in the first half of 2016.
4. Auditor's Reporting Model	Reproposal	On August 13, 2013, the Board proposed auditing standards and related amendments on the auditor's report and the auditor's responsibilities regarding other information. The staff has indicated that it analyzed the comments received on the proposal and is drafting a reproposal for the Board's consideration. The staff has indicated that it anticipates recommending the Board issue a reproposal of the auditor's reporting standard in the second quarter of 2016. The staff has indicated that it is evaluating the proposed other information standard in light of comments received and anticipates making a recommendation at a later date.

PCAOB Standard Setting Agenda – December 31, 2015

Other Projects		
Project	**Project Direction**	**Summary**
5. Auditing Accounting Estimates, Including Fair Value Measurements and Related Disclosures	Proposal	The proposal is expected to include revisions to current standards on auditing accounting estimates. The staff has indicated the proposal will include considerations of responses to the staff consultation paper issued in August 2014 and of discussions during meetings of the Standing Advisory Group and the Investor Advisory Group.
6. The Auditor's Use of the Work of Specialists	Proposal	The proposal is expected to include revisions to current standards in response to the increased use and importance of specialists. The staff has indicated the proposal will include considerations of responses to the May 2015 staff consultation paper and of discussions during meetings of the Standing Advisory Group and the Investor Advisory Group. The staff has indicated a plan to recommend that the Board closely coordinate the development and timing of any potential rulemaking for this project with the Auditing Accounting Estimates project.
7. Quality Control Standards, Including Assignment and Documentation of Firm Supervisory Responsibilities	Staff Consultation Paper	The staff has indicated that it is exploring whether changes to PCAOB quality control standards – including improvements related to assignment and documentation of firm supervisory responsibilities - could prompt firms to improve their systems of quality control. This project is expected to consider relevant research, input from the Standing Advisory Group, observations from the Board's oversight activities and activities of international audit regulators and standard setters, as well as related PCAOB activities, specifically, the root cause analysis and audit quality indicator initiatives.
8. Confirmation	Reproposal	The 2010 proposal included a new confirmation standard to supersede the PCAOB's existing confirmation standard, AU section 330, *The Confirmation Process.* The staff is expected to draft a reproposal based on comments received.

2016 Mutual Funds and Investment Management Conference

March 15, 2016

Matt Giordano
Chief Accountant
Division of Investment Management

Chief Accountant's Office, Division of Investment Management

- Perform Analysis and Review of Financial Information for IC Filings under the Federal Securities Laws
  - Financial Statements as Required by Sarbanes-Oxley Act of 2002
  - Filings Which Need to be Declared Effective
- Provide Guidance on IC and IA Accounting, Auditing, and Regulatory Matters

Chief Accountant's Office, Division of Investment Management

- Written Consultations – Content of Correspondence
  - Commission's OCA's guidance www.sec.gov/info/accountants/ocasubguidance.htm
  - Must include conclusions of the registrant, auditor, and audit committee
- Contact Information
  - IMOCA@sec.gov
  - 202-551-6918

Regulatory Update

Concept Release

- Possible Revisions to Audit Committee Disclosures

Proposal

- Investment Company Reporting Modernization
- Liquidity Management Programs for Funds and Swing Pricing

Other Items

- Corp Fin Disclosure Effectiveness Project

FASB Disclosure Framework Project (Proposed ASU) Fair Value Measurements (Topic 820)

Removal of Existing Disclosure Requirements

* Amount and reasons for transfers between level 1 and level 2 of the fair value (FV) hierarchy
* Policy for timing of transfers between FV hierarchy levels
* Valuation processes for level 3 FV measurements
* Change in unrealized gain/loss for the period in earnings on recurring level 3 FV measurements *(for private entities)*

Modification of Existing Disclosure Requirements

* For investments that use the practical expedient (valuation based on NAV calculation)
  1) Timing of liquidation of the investee's assets
  2) Date when redemption restrictions will lapse
  ^ If data has been communicated or is publicly available
* **Clarify** measurement uncertainty communication
* Reconciliation of level 3 balances no longer required (*private entities*)

Additional Disclosure Requirements

* Level 3 FV measurements = range, weighted average, and time period used to develop significant unobservable inputs
* Changes in unrealized gains and losses for the period included in earnings for recurring levels 1-3 fair value measurements held at the end of the reporting period, disaggregated by level of the fair value hierarchy

Note: Private Companies excluded from requirements

FASB Disclosure Framework Project: Fair Value Measurements (Exposure Draft)

Comment Period Closed February 29th

Letters received from a variety of different industry groups

Effective Date

Will be based upon redeliberation of Proposed Release - factoring in comment letters and stakeholder feedback

Considerations

* What will be the additional costs to implement the proposed disclosure changes and will those costs be significant?
* Will there be additional risk added to the financial reporting process to implement changes?
* Should additional guidance be needed if the Proposed ASU 235 is finalized?

FASB Disclosure Framework Project (Proposed ASU): Notes to Financial Statements (Topic 235)

Objective

Look to improve the *disclosure* effectiveness of Notes to the Financial Statements by helping entities omit immaterial information

Main Provisions

1) Materiality = defined as a legal concept (observe the U.S. Supreme Court definition)
2) Materiality = applied to quantitative and qualitative disclosures individually or in the aggregate in the context of the financial statements as a whole
3) Omission of immaterial disclosure would **not** be considered an accounting error

Other Provisions

* Each Accounting Standard Topic would state entities shall provide disclosures if they are material
* Each Disclosure Section would refer readers to Topic 235 for appropriate exercise of discretion
* Does not apply to recognition or measurement requirements, only to disclosure requirements

FASB Disclosure Framework Project (Proposed ASU): Notes to Financial Statements (Topic 235)

Comment Letters

Period closed in December with 50+ comment letters submitted to FASB

Effective

Upon issuance where entities may apply the changes prospectively or retrospectively

Thoughts/Impacts

* Discussions with auditors on material/immaterial disclosures when executing discretion?
* Board (Audit Committees) – What will be the communications on disclosures that are deemed immaterial? Will this create additional work for Boards to oversee and review?
* Are there other disclosure requirements (regulatory), which may impede implementation?
* Entities will need to weigh omission risk and its impacts?

On the Horizon: Other FASB Agenda Items

Recognition & Measurement
- Accounting for Financial Instruments
- Revenue Recognition

Presentation & Disclosure
- Disclosure Framework – Income Taxes
- EITF Issue 15-F – Cash Flows

Conceptual Framework
- Measurement & Presentation

Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits

- PCAOB adopted new rules on December 15, 2015 to provide more information to investors about who is participating in public company audits
  - Subject to SEC approval (SEC published notice seeking public comment on February 8, 2016)
- Form AP would be publicly available on the PCAOB's website and would disclose:
  - The name of engagement partner responsible for issuing the firm's audit report
  - The name, location, and extent of participation of other accounting firms whose participation exceeded 5% of the total audit hours
  - The number and aggregate extent of participation of all other accounting firms that took part in the audit whose individual participation was less than 5% of total audit hours
- Form AP filing deadlines
  - In most cases 35 days after the auditor's report is first included in a filing with the SEC
  - IPOs – 10 days after the auditor's report is first included in a filing with the SEC
- Effective dates
  - Name of the audit partner would be required for auditors' reports issued on or after January 31, 2017, or three months after SEC approval of the final rules, whichever is later
  - Other accounting firms disclosures would be required for auditors' reports issued on or after June 30, 2017

Auditing Accounting Estimates, Including Fair Value Measurements and Related Disclosures

- PCAOB staff consultation paper issued August 19, 2014
- Considering developing single standard that would supersede existing standards to:
  - Align with risk assessment standards
  - Retain substantive testing approaches, but include requirements applying to accounting estimates and fair value (FV) measurements
  - Establish more specific audit requirements on the use of third parties in developing accounting estimates and FV measurements
  - Create more comprehensive standard on auditing accounting estimates and FV measurements
- Alternative approaches considered
  - Issue staff guidance
  - Develop a separate standard on auditing FV of financial instruments in addition to existing standards
  - Enhance existing standards on accounting estimates and FV measurements through targeted amendments
- Next steps
  - Any potential rulemaking may be coordinated with the Specialists project

The Auditor's Use of the Work of Specialists

- PCAOB staff consultation paper issued May 28, 2015
- Considerations for potential revisions include improving the auditor's:
  - Oversight of the work of an auditor's specialist, whether employed or engaged
  - Evaluation of the objectivity of an auditor's engaged specialist
  - Evaluation of the work of a company's specialist
- Alternative approaches considered
  - Issue staff guidance
  - Revising standards related to the auditor's evaluation of the work of an auditor's specialist
    - Develop a separate standard for using the work of an auditor's specialist
    - Extend the supervision requirements in AS 10 to an auditor's engaged specialist
  - Revising how the auditor evaluates the objectivity of an auditor's specialist
    - Applying the requirements of Regulation S-X Rule 2-01 in PCAOB standards to engaged specialists
    - Applying an approach for an auditor's engaged specialist that would incorporate some but not all elements of Regulation S-X Rule 2-01 ("Enhanced Objectivity Approach")
  - Revising performance requirements for auditor's use of the work of a company's specialist
    - Amend AU 336 by removing certain provisions that may be considered to limit the auditor's responsibilities for evaluating the work of a company's specialist and clarify other requirements
    - Rescind AU 336 which would result in auditors following other applicable PCAOB standards when using the work of a company's specialist and evaluating evidence provided by the company's specialist similarly to any other evidence provided by the company
- Next steps
  - Expected proposal of a standard for comment in the third quarter of 2016
  - Any potential rulemaking may be coordinated with the Auditing Accounting Estimates Project

Audit Quality Indicators

- PCAOB issued concept release on July 1, 2015
- Sought comment on 28 possible audit quality indicators (AQI) falling into 3 groups and how they might be used by audit committees, audit firms, investors, and regulators
  - Audit professionals – includes availability, competence, focus of those performing the audit
  - Audit process – includes tone at the top and leadership, incentives, independence, attention to infrastructure, record of monitoring and remediation
  - Audit results – includes financial statements, internal control, going concern, communications between auditors and audit committees, enforcement and litigation
- Concept release also sought comment on
  - How AQI data should be obtained and distributed
  - Whether providing AQIs should be required or voluntary
  - Which audits and audit firms should be subject to AQI reporting
  - Whether any requirements to provide AQIs should be phased in
- Next steps
  - The PCAOB's project on Quality Control Standards is considering input and observations from the PCAOB's AQI initiatives and root cause analysis

Auditor's Reporting Model

- Proposed on August 13, 2013
- Would require more information in the auditor's report than the traditional pass-fail opinion, including:
  - Discussion of critical audit matters
  - Information on the auditor's evaluation of "other information" accompanying the audited financial statements
  - Auditor tenure
- Would require additional procedures to evaluate, based on the audit, whether information outside the financial statements contained:
  - Material inconsistencies with amounts or information in the financial statements
  - A material misstatement of fact
- Next steps
  - Expected reproposal of the auditor's reporting standard in second quarter of 2016
  - Staff continuing to evaluate the proposed other information standard based on comments received and anticipates making a recommendation at a later date

Enforcement Update

- Information about the Division of Enforcement
  http://www.sec.gov/enforce
- Themes of Recent Enforcement Cases
- Common Fraud Themes

Business Interruption

- Service Providers & Exchanges
- Impact to Mutual Funds
- Calculation of the NAV
- Business Continuity & Disaster Recovery Plans
- Legal & Regulatory Issues
- Disclosure

Staff Accounting and Disclosure Comment Topics

Financial Statement Comments

- Fair Value
  - Valuation
  - Hierarchy vs Liquidity
- Related Party Disclosure
  - 17a-7 Transactions
  - Interfund Lending
- Organization and Offering Costs

Other Topics

- Rule 19b-1(e) Relief Requests
  - Submit draft request to IMOCA@sec.gov before filing with the Commission
  - IM's Chief Accountant's Office and Chief Counsel's Office will review the request
- Rule 30e-1(e) Relief Requests for Good Cause
  - Fiscal years changing by 1 month or 7 months
  - Submit draft request to IMOCA@sec.gov
- Rule 3-13 of Reg S-X
  - Submit draft request for disclosure or filing relief to IMOCA@sec.gov
- IC Act Notices and Orders
  http://www.sec.gov/rules/icreleases.shtml

Resources

- Topical Reference Guide – Accounting and Auditing
  - www.sec.gov/divisions/investment/guidance.shtml#accounting
- Valuation Cases
  - RICs and BDCs: See Valuation Bibliography – www.sec.gov/divisions/investment/icvaluation.htm
  - Private Funds: http://www.sec.gov/investment (Investment Management → Litigation → Valuation)

Other Hot Topics

- Deferred Tax Assets – Master Limited Partnerships
- Derivative Instruments – Characterization & Categorization
- ASU 2015-7: Investments in Entities that Calculate NAV
- ASU 2015-01: Elimination of “Extraordinary Items” from GAAP

Q & A

SESSION 3-C: Untangling the EU Regulatory Process—How Does It Work?

Susan M. Olson, Moderator
ICI Global

Patrice Bergé-Vincent
ICI Global

Gregory P. Dulski
Federated Investors, Inc.

Ida L. Levine
Capital International, Ltd.

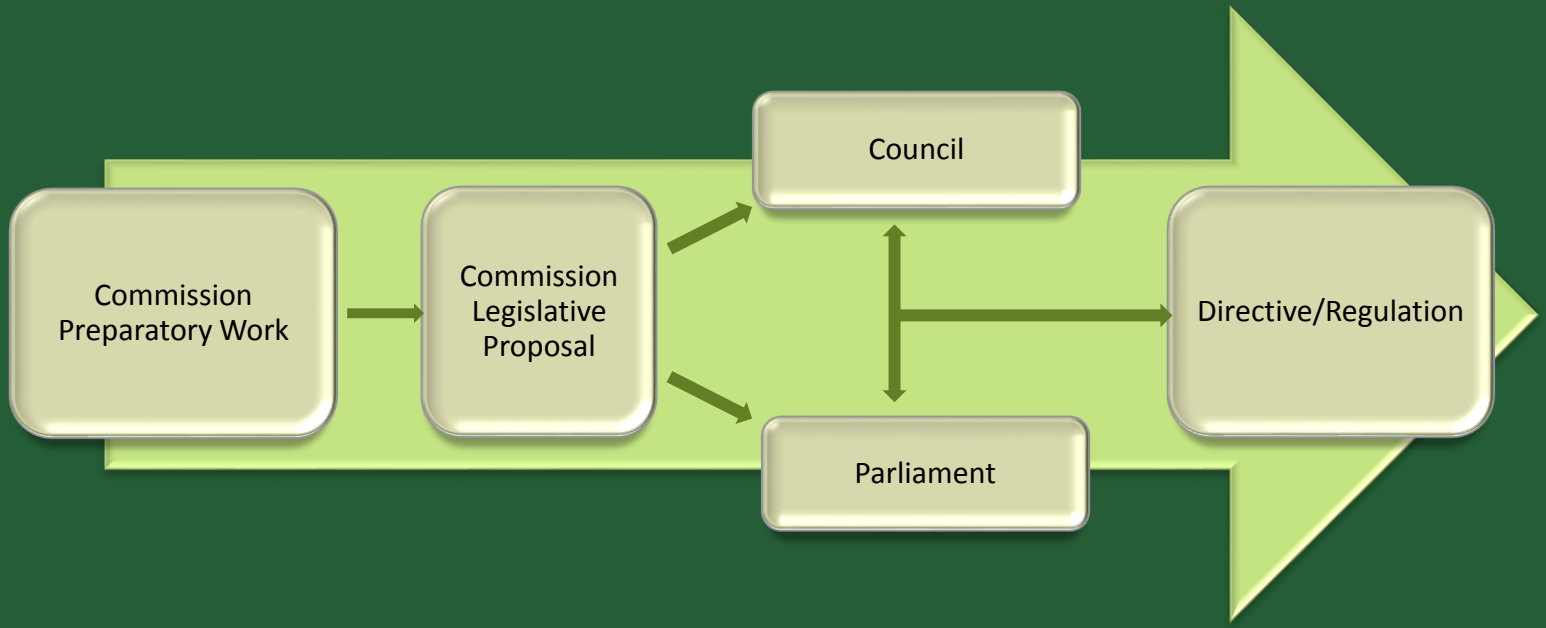
The European Union

What is the European Union and how is it organized?

European Regulatory Process – Key Players

- **European Commission**
  Commissioners, Directorate General (DG)
- **European Parliament**
  Group Coordinators, Committees (e.g., ECON), Rapporteur Shadow Rapporteurs
- **Council**
  Permanent Representatives, Member State Experts
- **Interested Regulators**
  Member States (*e.g.*, FCA, AMF, BaFin), European (*e.g.,* ESMA, EBA, ESRB)
- **Trade Associations**

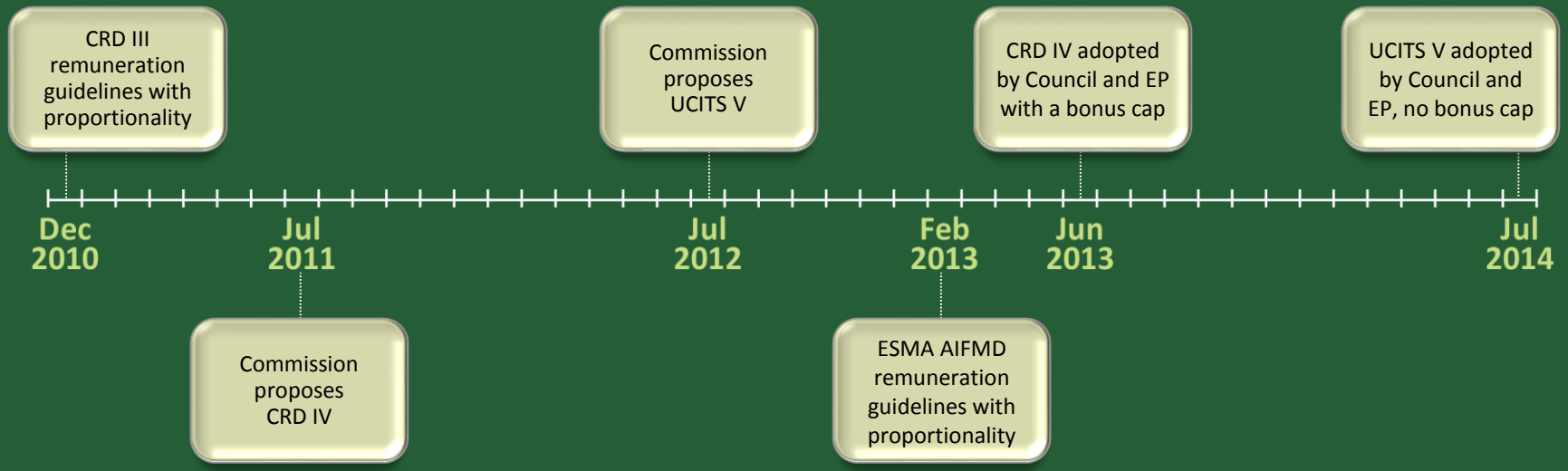
Ordinary Procedure (Co-decision Procedure)



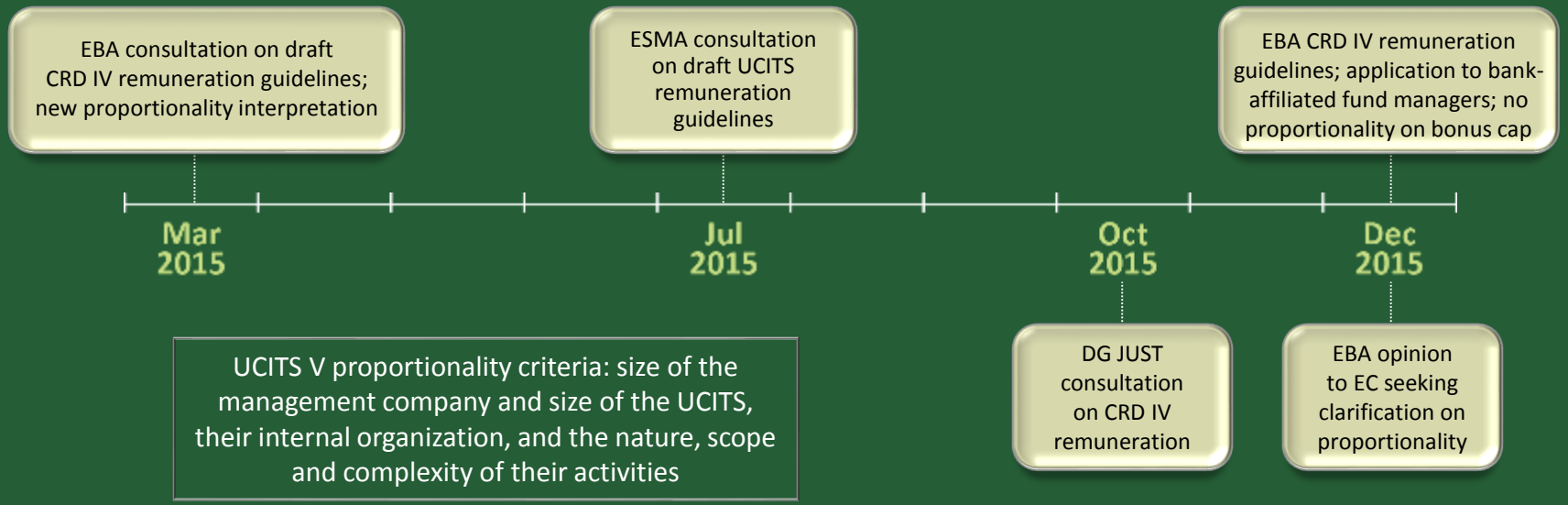
Hierarchy of EU Regulatory Framework

Level 1 (L1)	Directive or Regulation
Level 2	Delegated act supplements or amends non-essential elements of L1
	Regulatory technical standards (RTS)
	Implementing acts needed for uniform implementation
	Implementing technical standards (ITS) are technical in nature
Level 3	Guidance
Level 4	Enforcement

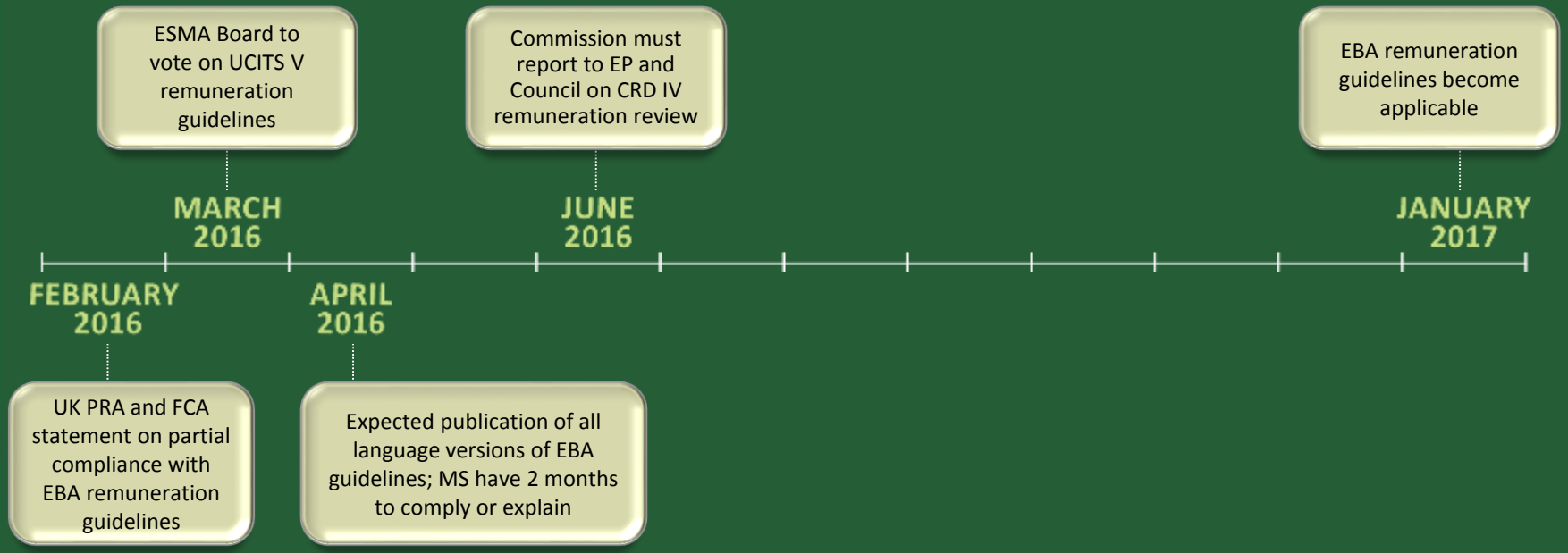
Regulation of Fund Manager Remuneration – Phase 1



Regulation of Fund Manager Remuneration – Phase 2

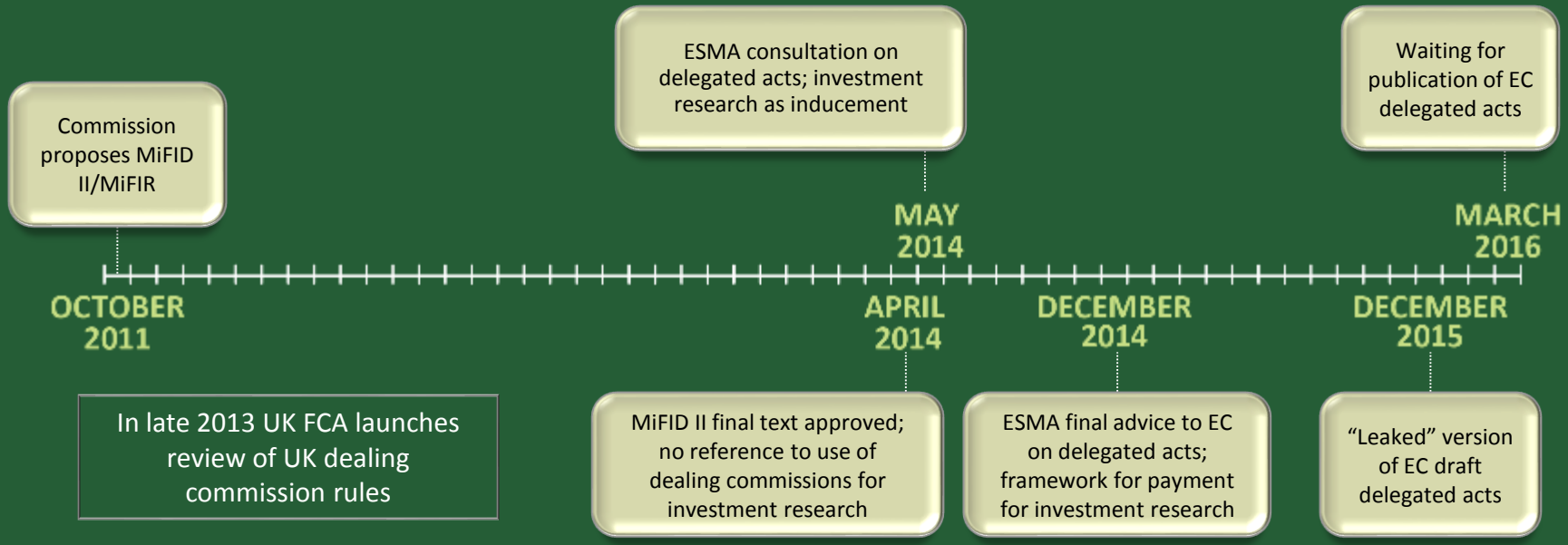


Regulation of Fund Manager Remuneration – Phase 3



Money Market Fund Regulation (MMFR)

MiFID II – Use of Dealing Commissions for Investment Research



HOME

SESSION 3-D: The DOL Fiduciary Rule: What You Need to Know

David M. Abbey, Moderator
Investment Company Institute

Bradford P. Campbell
Drinker Biddle & Reath LLP

Robert J. Doyle
Prudential Financial

Stephanie L. Napier
The Vanguard Group, Inc.

How Did We Get Here?

ERISA 101: "Fiduciary" status under ERISA and Internal Revenue Code presents unique challenges

- Definition
- Standards of conduct ("Solely in the Interest," "Exclusive Purpose")
- Prohibited transactions
- Excise taxes
- Exemptions

"Investment Advice" Fiduciaries –

- 1975 Rule – Five part test
- 2010 Proposal
- 2015 Proposal

Challenges to Rule

- Timing of final rule
- Legislation
  - *Strengthening Access to Valuable Education and Retirement (SAVERS) Act*
  - *Affordable Retirement Advice Protection (ARAP) Act*
- Litigation?
  - Likelihood of a stay
  - Focus of challenge (jurisdictional, regulatory impact)

What Now: The 2015 Proposal and Potential Changes

Who's In?

Covered Arrangements – ERISA-covered pension and welfare plans, tax qualified plans, IRAs, HSAs, Coverdale Educational Savings Programs

Covered Persons –

- Advice for a fee to a plan, plan fiduciary, plan participant or beneficiary, IRA or IRA owner
- Recommendations on advisability of acquiring, holding, disposing, or exchanging securities or other property, including recommendations involving rollovers
- Recommendations as to the management of securities or other property (including rolled over assets)
- Appraisals, fairness opinions or similar statements
- Recommendations in relation to the selection of investment managers or other fiduciaries

The 2015 Proposal (cont.)

Who's Out?

- Counterparty (sales) transactions
- Swap and securities based swap transactions
- Employee Communications with plan fiduciary
- Platform Providers / Selection and Monitoring Assistance
- Appraisals, fairness opinions and similar statements for ESOPs and CITs
- Investment Education

The 2015 Proposal (cont.)

If In – Then What?

- Best Interest Contract Exemption
  - Written contract
  - Impartial conduct – best interest standard
  - Warranties
  - Disclosure of compensation (initial, annual, website)
  - DOL data request / Public disclosure
- PTE 84-24

Implications

- Manufacturers
- Registered Investment Advisers / Broker Dealers
- Plan Sponsors and Participants

Case Studies

- Call and walk-in centers
- Asset allocation modeling and investment matching
- Plan menu selection
- Rollover considerations
- Tailored or targeted communications

Getting Ready For The Rule

- Analyze rule and its implications for all your products and services
- Identify potential risks and impact on business model
  - Risks and impact vary based on type of firm, services and products
  - Assessment requires involvement of business, legal, IT, etc.
- Determine compliance strategy and implement

Compliance Strategy Involves Choices

- "BIC" and/or other exemptions
- Avoid fiduciary status; make no "recommendations"
- Abandon certain market segments
  - Small plans/IRAs
- Convert to level fee programs
  - Wrap fee
  - Uniform fee products
  - Other

SESSION 3-E: Is the Sky Falling? The Shifting Role of Liquidity Risk Management and Regulation

Dorothy M. Donohue, Moderator
Investment Company Institute

Sean Collins
Investment Company Institute

William G. De Leon
PIMCO

Ruth S. Epstein
Stradley Ronon Stevens & Young, LLP

Jasmin Sethi
BlackRock, Inc.

Sarah G. ten Siethoff
U.S. Securities and Exchange Commission

Outline of Presentation

- SEC's Rationale for Proposing Liquidity Risk Management Program Rule
- Scope of the Proposal
- Written Program Requirements
  - Multi-Factor Assessment of Liquidity Risk and Ongoing Monitoring
  - Classification and Disclosure of Liquidity for Each Portfolio Holding
  - Three-Day Liquid Asset Minimum
  - Board Approval and Oversight
- Swing Pricing
- New Disclosure Requirements

SEC's Rationale for Proposing Liquidity Risk Management Program Rule

- Reduce risk that funds will be unable to meet redemptions.
- Respond to growth in assets of fixed income funds and alternative funds.
- Respond to evolution of market towards shorter settlement periods along with some mutual funds holding securities with longer settlement periods.
- Provide an additional tool to mitigate potential dilution of shareholder interests.
- Respond to staff finding great variance in funds' liquidity risk management practices.

Scope of the Proposal

- Funds covered: Mutual funds and open-end ETFs regardless of investment strategies or portfolio holdings.
- Not covered: Closed-end funds, money market funds, UITs.

Written Program Requirements: Multi-Factor Assessment of Liquidity Risk and Ongoing Monitoring

- Liquidity Risk: "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value."
- Assess and periodically review liquidity risk, considering:
  - Short-term and long-term cash flow projections;
  - Investment strategy and liquidity of portfolio assets;
  - Use of borrowings and derivatives for investment purposes; and
  - Holdings of cash and cash equivalents, borrowing arrangements, and other funding sources.

Written Program Requirements: Classification and Disclosure of Liquidity for Each Portfolio Holding

- Classify and review liquidity of *each portfolio position* (or portion thereof), based on number of days within which it would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale:
  - Convertible to cash within 1 business day
  - Convertible to cash within 2-3 business days
  - Convertible to cash within 4-7 calendar days
  - Convertible to cash within 8-15 calendar days
  - Convertible to cash within 16-30 calendar days
  - Convertible to cash in more than 30 calendar days
- Price immediately prior to sale: fund, in classifying, must determine whether the position's expected sales price is reasonably expected to move the asset's market price, independent of other market forces.
- Disclose liquidity classification for each position (or portion thereof) on a monthly basis to SEC on proposed Form N-PORT (only quarter-end classification would be publicly available).

BlackRock Example of Five-Tier Liquidity Classification Asset Type Mapping

BlackRock recommends an objective tiering scheme that can be applied consistently across asset managers.

	Tier 1	Tier 2	Tier 3	Tier 4	Tier 5
Definition	Cash and securities that can be readily converted to cash in normal and stressed markets at close to the existing market price.	Securities that can be readily transacted in normal market environments and remain readily transactable (at wider bid-ask spreads than Tier 1) even during stressed markets.	Securities that can be transacted (at wider bid-ask spreads than Tier 2) in normal market environments but become somewhat more difficult to transact with immediacy (or at higher bid-ask spreads than Tier 2) in stressed markets	Securities that can be transacted at wider bid-ask spreads than Tier 3) in normal market environments, but due to a smaller investor base or other reasons, may become more difficult to transact with immediacy (if at all or at much wider bid-ask spreads than Tier 3) in stressed markets	Securities which require heavy negotiations to trade in normal and stressed markets
Types of Securities	• Cash				
	• AAA / AA / A Rated Govt. Bonds • Agency MBS TBAs • Pre-Refunded Munis	• BBB / BB / B Rated Govt. Bonds • Agency MBS (ex TBAs) • On-the-Run Senior ABS • IG Munis • IG Corporate (ex EM)	• Below B Rated Govt. Bonds • Senior CMBS • Off-the-Run Senior ABS • Subordinate ABS • Senior Non-Agency RMBS • GSE Risk Sharing Deals • HY Munis • Tender Option Bonds • EM IG Corporates • HY Corporates (ex EM) • Syndicated Bank Loans > $250m issue size • AAA / AA / A CLOs • Capital Securities	• Subordinate CMBS • Subordinate Non-Agency RMBS • Securitized Asset Residuals/Equity • Non-Rated Munis • EM HY Corporates • Middle Market Loans < $250m issue size • BBB and below CLOs • Defaulted Securities with public pricing	• Securities with non-public pricing (e.g., certain defaulted securities, bankruptcy claims, etc.) • Securities restricted from trading • Mortgage Servicing Rights • Securities labeled as 'Private', including unlisted equities
	• Listed Developed and EM Equity • ETFs	• Frontier Markets Equity	• Preferred Equity		
	• Interest Rate Swaps and Swaptions • FX • Futures				
	MOST LIQUID				LEAST LIQUID

PIMCO Alternative

PIMCO recommends an alternative asset classification scheme (only in the case of the SEC ultimately determining asset classification system is crucial element of liquidity risk management program).

- Cash or other assets that are available to meet redemptions in 0-1 business day, as determined by investment manager
- Cash or other assets that are available to meet redemptions in 2-7 calendar days, as determined by investment manager
- All other assets
- 15% Standard Assets (if necessary)

Written Program Requirements: Three-Day Liquid Asset Minimum

- "Three-day liquid asset minimum"
  - Each fund determines, periodically reviews, and abides by its own "three-day liquid asset minimum."
  - "Three-day liquid assets" consist of cash and any portfolio position (or portion thereof) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.
- Other elements of managing liquidity risk:
  - "15% standard asset" limitation: codifies funds' existing 15% limit on illiquid assets.
  - Formal redemption-in-kind policies and procedures (if applicable).

Written Program Requirements: Board Approval and Oversight

- Fund board (including a majority of independent directors):
  - Approve liquidity risk management program (including each fund's "three-day liquid asset minimum") and material changes;
  - Review written report (provided annually) on adequacy and effectiveness of fund's program; and
  - Approve entity/individual(s) responsible for program (not solely portfolio managers).

Swing Pricing Proposal Generally

- Amended Rule 22c-1: Permit, but not require, open-end funds (except money market funds and ETFs) to use swing pricing to allocate transaction costs to redeeming and purchasing fund shareholders (NAV "swings" downward with net redemptions, and upward with net purchases).
- SEC believes swing pricing could be useful tool in mitigating potential dilution of fund shareholders.

Particulars of Swing Pricing Proposal

- Requirements for funds adopting swing pricing:
  - Policies and procedures specify a swing threshold and swing factor;
  - Fund board approves policies and procedures and entity/person(s) responsible for administering them;
  - Report NAVs as adjusted; and
  - Retain calculations supporting NAV adjustments.

Swing Threshold/Swing Factor

- Swing threshold is the amount of net purchases into or net redemptions from a fund, expressed as a percentage of the fund's NAV, that triggers the initiation of swing pricing.
- Swing factor is the amount, expressed as a percentage of the fund's NAV, by which a fund adjusts its NAV per share when the level of net purchases or net redemptions exceeds the fund's swing threshold.

Questions

?

"Nudging" Better Behavior

Nancy B. Rapoport
Acting Executive Vice President and Provost, UNLV
Garman Turner Gordon Professor of Law, UNLV Boyd School of Law
University of Nevada

UNLV | WILLIAM S. BOYD SCHOOL OF LAW

"Nudging" Better Behavior

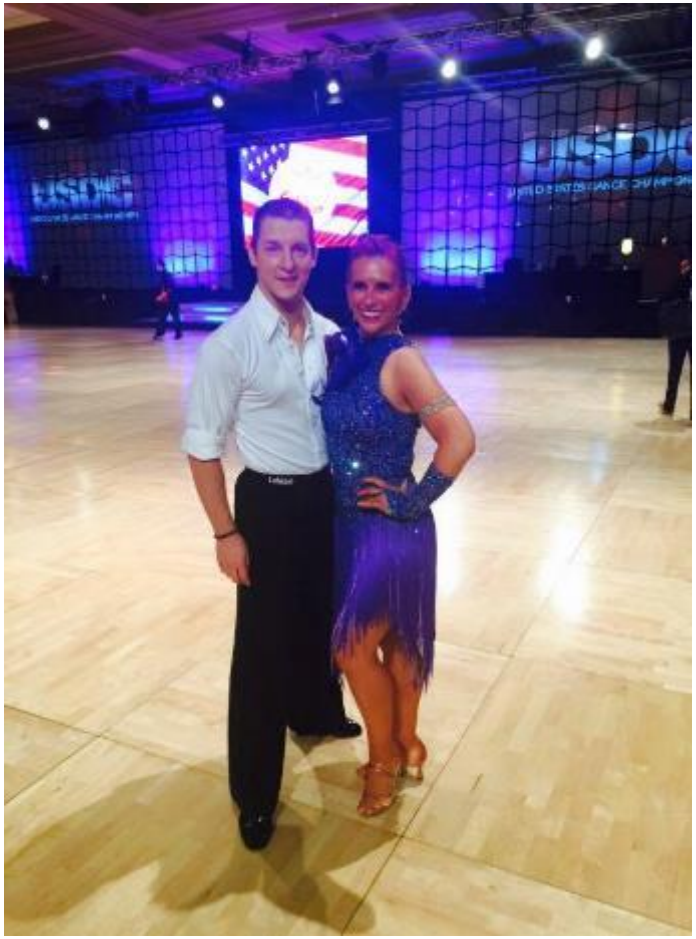
Nancy B. Rapoport
Acting Executive Vice President & Provost,
University of Nevada, Las Vegas
Garman Turner Gordon Professor of Law,
William S. Boyd School of Law
Affiliate Professor of Business Law & Ethics,
Lee Business School
http://www.law.unlv.edu/faculty_nancyRapoport.html
http://nancyrapoport.blogspot.com/

UNLV | WILLIAM S. BOYD SCHOOL OF LAW

What would you change about your work, if you could change something?

Every step you see has a "prep step" that created it.

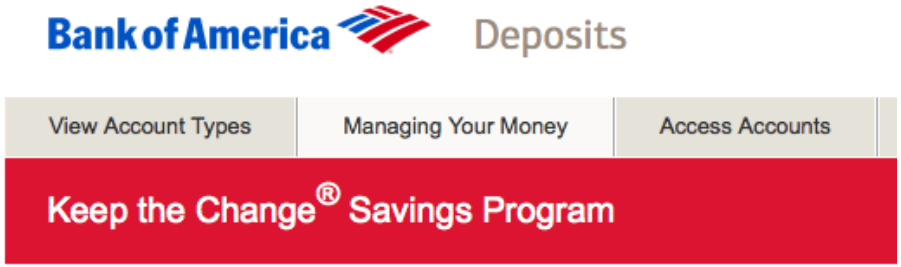
"Prep step" in dance = incentives at work.



Main points:

- People work to meet the incentives they're given—whatever those incentives may be.
  - To change behavior, it's important first to identify the incentives that triggered that behavior.
  - Every change in incentives involves a risk of creating new, bad incentives.
- Humans make certain cognitive errors.
- An organization's culture matters.

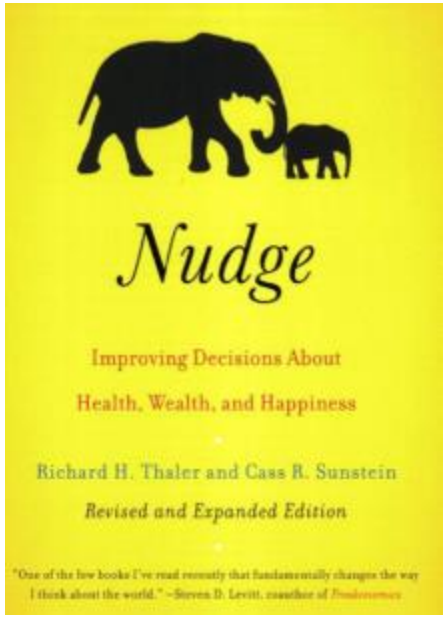
Subtle default rules and other ways of changing behavior:



Examples of bad incentives:

Let's start with why I want to "nudge" organizations:

- My work as a fee examiner got me started thinking about this topic.
- Are there little changes that we could make inside organizations that might help them:
  - Run better/be more profitable?
  - Serve clients better?
  - Encourage more ethical behavior?

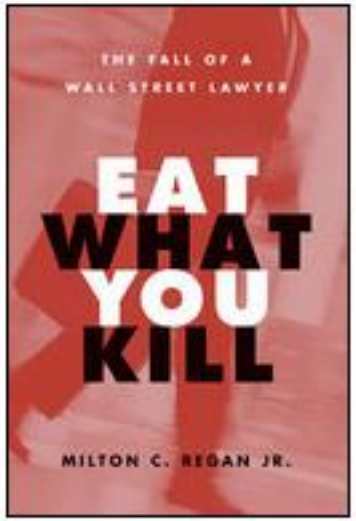


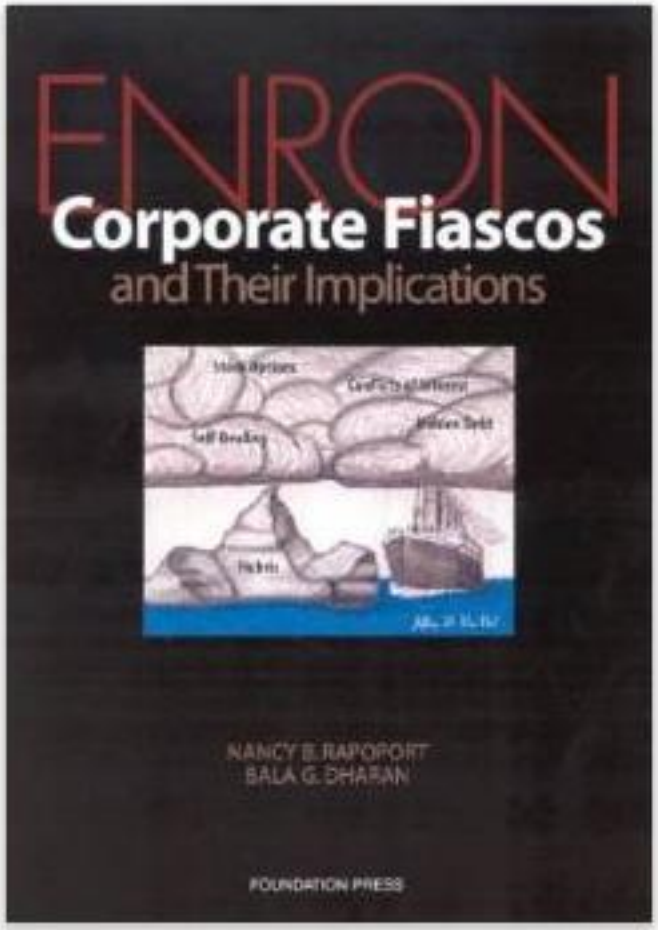
All organizations can use a nudge or two.

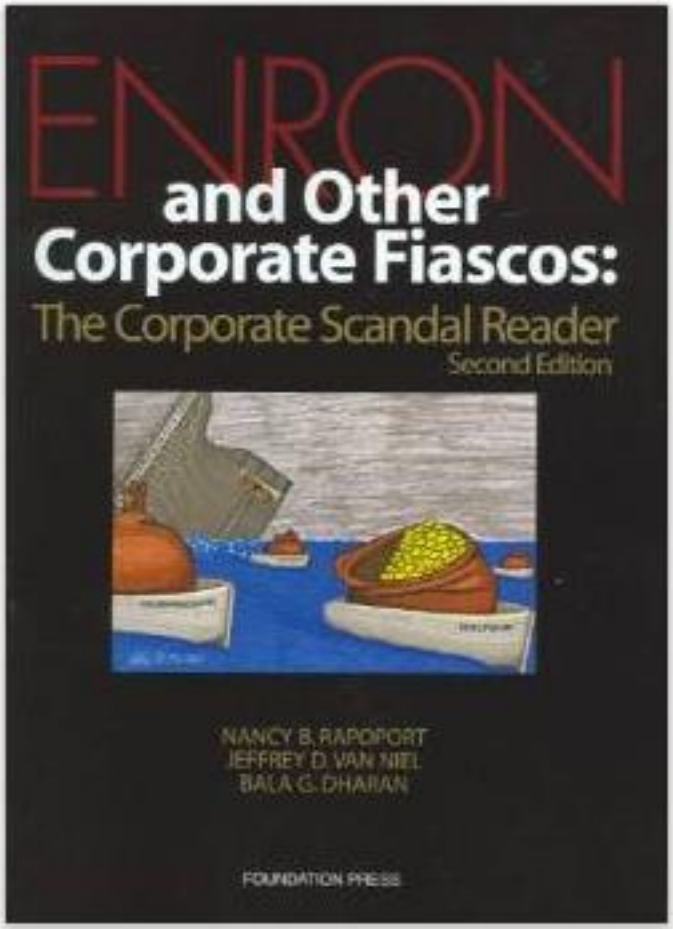
- A law firm isn't that unique an organization.
- It's all about an organization's culture.

To change culture, first figure out what it is.

- It's not what we say, it's what we do.




ENRON
Corporate Fiascos
and Their Implications
NANCY B. RAPOPORT
BALA G. DHARAN
FOUNDATION PRESS


ENRON
and Other
Corporate Fiascos:
The Corporate Scandal Reader
Second Edition
NANCY B. RAPOPORT
JEFFREY D. VAN NIEL
BALA G. DHARAN
FOUNDATION PRESS

What can we learn from Enron & more recent corporate scandals?

- RULE #1: Never underestimate human cognitive errors.
  - The individual.
  - The situation.

What can we learn from Enron & more recent corporate scandals?

- All other rules flow from Rule #1:
  - Checks and balances & human cognition.
    - "Rules on paper": not enough.
  - Choosing good incentives and "nudges" can help.
  - "Devil's advocate."

Every organization has a culture—even law firms and corporate offices.

- When/how workflow gets recorded (e.g., billable time)
- Cross-selling inside the firm.
- How more experienced employees train newer ones.
- How staff members are treated.
- **What is your organization's culture?**

Can we "nudge" people to behave differently?

- Both definitions of "nudge" work very well.
- What incentives work for/against the behavior we want?
- What default rules (opt-in? opt-out?) might we use to change behavior?
  - Opt-in vs. opt-out: organ donations.

Why should we care—especially if we're lawyers?

- Supervisory lawyers have an ethical duty to monitor their employees' compliance with ethics rules.
- In some situations, non-compliance with matter-specific rules can cost firms money.
  - E.g., not billing in tenths of an hour in large chapter 11 cases.
- Now is a good time to encourage law firms to change.
  - Lots of pressure on BigLaw.

A tale from my past:

- Bonuses and the 1,800 hour year.
  - At what increment was it worth it to me to work those extra hours for a bonus?
  - Perverse incentives (from the client's perspective) to work more slowly.
  - Does "more hours worked" translate to "more value to clients"?

Some basic cognitive errors and biases:

- Cognitive dissonance.
- Diffusion of responsibility.
- Anchoring.
- Confirmation bias.
- Hindsight bias.
- Social pressure.
- Top all of that off with the exhaustion of a full-time practice, and you can see how errors get made.

Cognitive dissonance.

"I am a good person."

"I am doing a bad thing."

"There's a good reason I'm doing this."

When it comes to cognitive dissonance, there are no lobsters, only frogs.

Other personal and group cognitive errors:

- Diffusion of responsibility (also called the "bystander effect").
  - "Someone else will do it"—the Kitty Genovese story.
  - (A new book argues that fewer people were witnesses—maybe just 6—but that still implicates the error.)
  - Bystander effect happens frequently.

Kitty Genovese

Kitty Genovese, picture from *The New York Times* article: "Thirty-Eight Who Saw Murder Didn't Call the Police"

Photo available at http://en.wikipedia.org/wiki/Murder_of_Kitty_Genovese.

Anchoring in action:

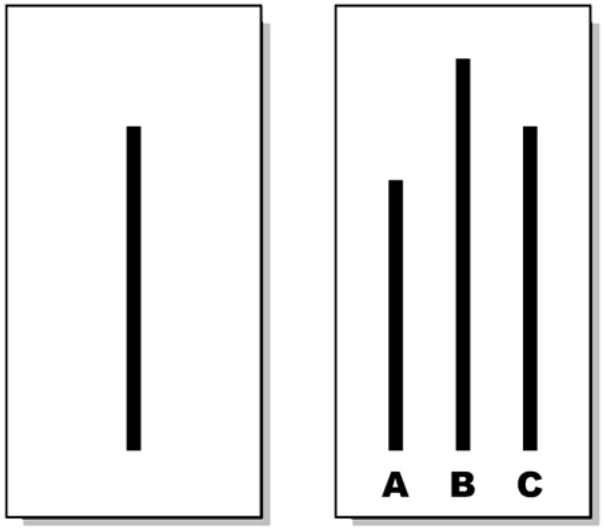
- Focusing on one factor = anchoring error.
- Try this one yourself.
  - (No calling out if you've seen it before!)

Confirmation bias and hindsight bias.

- Confirmation bias = new information interpreted to confirm old beliefs.
- Hindsight bias = "I knew it all along" interpretation of new information.

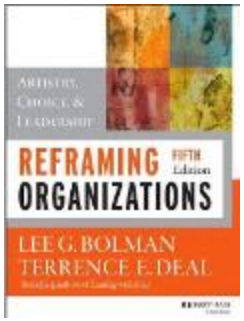
Social pressure and changes in a group's norms:

- Solomon Asch.
- The two most likely cognitive errors affecting most organizations?
  - Social pressure and diffusion of responsibility.



Setting the correct cultural expectations is a first step—but not the only necessary one.

- Does the firm encourage the sharing of clients, or is it an "eat what you kill" kind of system?
- Does the firm tolerate bad behavior from star performers?
  - The bankruptcy lawyer who ended up wearing federal prison orange.
- The "symbolic" frame and the stories we tell about an organization.

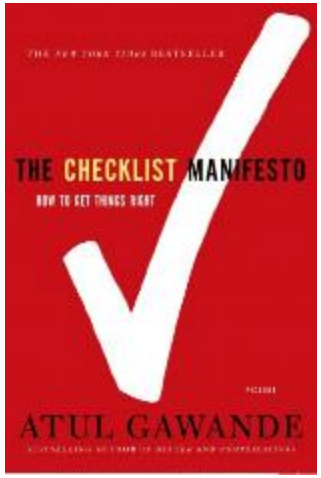


Starting to change culture—perceived losses and perceived gains

- What we take away will bother people more than what we give them.
  - Marissa Meyer's decision to take away Yahoo's flextime.

Options for nudging behavior

- Default rules (opt-in or opt-out?)
  - Possible application: timesheet entries
- Other incentives (e.g., changing compensation structure)
  - Possible application: cross-selling; mentoring associates
- Checklists
  - Possible applications: conflicts checks, staffing decisions



My world is the world of law firms:

- So let's take a look at certain types of "nudging" that we could do in a firm.
- Then we can apply nudging principles to other organizations.

Entering billable time:

- Make it easier for billers to keep track of their time on matters simultaneously.
- Make it easier for billers to get everyone to comply w/any client-specific or court-specific rules (like billing in 10ths of an hour in bankruptcy cases).
- Make it easier to avoid descriptions of work that aren't really descriptions (e.g., "attention to file").
- Software that helps with recording and reminding people to submit the hours on a timely basis?

Valuing billable time:

- Hours spent ≠ value of that time to the client.
- If billable hours are the benchmark for compensation, then people will tend to work s-l-o-w-l-y and will not want to devote much of their time to non-billable work w/i the firm.
- Develop metrics to "count" non-billable time w/i the overall compensation metric.

Setting staffing plans for each matter:

- Norms/checklists to determine the "standard" allocation of partners, associates, legal assistants—and force people to have to go through more hoops to move from those standard staffing plans.
  - Opt-out rather than opt-in.
  - Checklists might help.
- We can envision this type of norming in all sorts of organizations for staffing, budgets, etc.

Cross-selling w/i a company:

- Cross-selling needs to be figured into overall compensation rubric.
  - Department to department referrals; office to office referrals.
- One law firm has done this formula: Attorney profitability = revenue collected - costs attributable to that revenue (i.e., salary + overhead).

Mentoring new professionals:

- Mentoring vs. sponsoring.
- Again, if there are no tangible rewards for mentoring/sponsoring, then most of the more senior lawyers will gravitate toward that which is rewarded (fees).

Changing other non-billable efforts:

Billable hour work (and probably the amount collected, not just billed, to factor in the value of the work to the client)	Fixed-fee work (probably by using some calculation of the amounts budgeted for the work or by tracking the actual hours billed)	Contingency fee work	Work on behalf of the firm (committee work, mentoring)	*Pro bono* hours	Networking and other work that provides less immediately tangible benefits to the firm

The trick:

- Calibrating the percentage of compensation attributable to each of those categories.
- Too little on the non-billable side, and behavior doesn't change.

Some barriers to change

- Don't discount the "perceived losses" problem.
- Smart people will find workarounds to any changes that a firm imposes.
- Few firms want to be the "first" to make big changes.

Issues like training and mentoring aren't just for law firms.

- Investments in succession planning are important.
- Retention is less costly than constant turnover.

Let's go back to that first question:

What would you change about your work, if you could change something?

And, now, it's your turn:

- Ideas? Questions?
- For some of my ideas on this topic, see:
  - Nancy B. Rapoport, *"Nudging" Better Lawyer Behavior: Using Default Rules and Incentives to Change Behavior in Law Firms*, 4 ST. MARY'S J. L. ETHICS & MALP. 42 (2014).
  - Randy D. Gordon & Nancy B. Rapoport, *Virtuous Billing*, 15 NEV. L.J. 698 (2015).

ARTICLE

Nancy B. Rapoport

"NUDGING" BETTER LAWYER BEHAVIOR:
Using Default Rules and Incentives to Change Behavior in Law Firms

Abstract. In the changing landscape of law practice—where law firm profits are threatened by such changes as increased pressure from clients to economize and the concomitant opportunities for clients to shop around for the most efficient lawyers—are there ways to change how things are done in law firms so that firms can provide more efficient and ethical service? This article suggests that an understanding of cognitive biases and basic behavioral economics will help law firms tweak their incentives and default rules to promote the improved delivery of legal services.

Author. Gordon Silver Professor of Law, William S. Boyd School of Law, UNLV. Special thanks go to Hal Abramson, Jack Ayer, Mary Beth Beazley, Dustin Benham, Doug Berman, Marty Brimmage, Matthew Bruckner, Bernie Burk, George Connelly, Walter Effross, Billie Ellis, David Friedman, Jodie Garfinkel, Ted Gavin, Elias George, Lara Glaesman, Randy Gordon, Art Greenbaum, Jennifer Gross, Allyson Hennelly, Marvin Katz, Kerry Kleiman, Phillip Kunkel, Lacy Lawrence, Nettie Mann, Dave McGowan, Terry McNiff, Andrew Notaro, Orges Ormanidhi, Irving Picard, Morris Rapoport, Jean Sternlight, Scott Unger, Jeff Van Niel, and Jean Whitney, as well as to the wonderful professors of the Moritz College of Law at The Ohio State University, who helped me think through some of these issues at a faculty workshop.

ARTICLE CONTENTS

> *The structure of the large, modern law firm makes it easier for lawyers to be anonymous and to hide in the crowd where they are more likely to develop bad ethical habits. Hence, large law firms in particular should support structural changes that serve to counterbalance and compensate our natural tendencies to justify our misbehavior when we believe that no one is looking.*[1]

As a general rule, employees respond to the incentives that their employers give them.[2] Some of those incentives are explicit ("if you do *x*, *y*, and *z*, you'll get a bonus"), and some aren't (the people in the "in crowd" do *a*, *b*, and *c*, so if you want to be in the "in crowd," you should also do *a*, *b*, and *c*). The first step in changing behavior lies in realizing that the targeted behavior has already been triggered by existing

1. Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 680 (2011) (footnote omitted).

2. This truism dawned on me when we were studying what went wrong at Enron. *See generally* NANCY B. RAPOPORT, JEFFREY D. VAN NIEL & BALA G. DHARAN, ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER (Foundation Press 2d ed. 2009) (examining the ins and outs of the Enron-era scandals); NANCY B. RAPOPORT & BALA G. DHARAN, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (2004) (detailing the effect of the Enron scandal on the business and legal worlds and the lessons to be learned from the scandal); Nancy B. Rapoport, *Lessons From Enron—And Why We Don't Learn From Them*, COM. LENDING REV., May–June 2009, at 21 (pointing out the human element underlying corporate scandals); Nancy B. Rapoport, *Enron, Titanic, and the Perfect Storm*, 71 FORDHAM L. REV. 1373, 1378–85 (2003) (examining employee incentives and their effects at Enron).

Enron got from its employees exactly that which it had wanted to get. Want people to "think bigger" without the need to demonstrate the value of the resulting idea itself? Then reward people at the beginning of a project, rather than after it's shown a profit, as Enron did by building the economically ludicrous Dabhol power plant. *See, e.g.*, Sam Parry, *Enron's India Disaster*, CONSORTIUMNEWS.COM (Dec. 30, 2001), http://www.consortiumnews.com/2001/123001a.html (criticizing Enron's work in India). Want people to turn on their colleagues rather than encourage teamwork? Use a "rank and yank" system that routinely drops the bottom 10% of high achievers off the payroll. *See, e.g.*, John Schwartz, *As Enron Purged Its Ranks, Dissent Was Swept Away,* N.Y. TIMES, Feb. 4, 2002, http://www.nytimes.com/2002/02/04/business/as-enron-purged-its-ranks-dissent-was-swept-away.html?pagewanted=all&src=pm (analyzing Enron's internal governance). Want people to invent the dollar figures associated with profits for ideas that have no market corollary? Give them bonuses and let them use mark-to-market accounting without having a real "market" for comparison purposes. *Cf. Enron: The Smartest Guys in the Room*, SPIKE (Apr. 15, 2005), http://www.spike.com/video-clips/aiz715/enron-the-smartest-guys-in-the-room-mark-to-marketing (discussing Enron's creation and its profit structure). Enron's incentives encouraged the behavior that ultimately brought it down.

incentives.[3] The second step involves working backwards from the behavior to identify the incentives that created it. The third step, of course, is the most difficult: developing different incentives that trigger more of the behavior that you want without simultaneously triggering new behavior that you don't want. Even outside of work, incentives (and their companions—default rules that encourage or discourage certain behavior) are powerful forces in our lives.

Consider just how many of our daily decisions are driven by default rules and incentives. A few months ago,[4] I realized that Bank of America now returns my ATM card before asking me to input my password—presumably because it wants to make sure that its customers don't leave their cards in the machines.[5] Bank of America also has opt-in incentives to let its customers add a bit to their savings accounts whenever they use their debit cards to pay for something. Every time someone who's enrolled in the "Keep the Change" program makes a purchase with the card, the bank rounds up the purchase to the nearest dollar and deposits the difference in the customer's savings account.[6] As an extra incentive, the bank keeps track of how much a customer has saved by using the program. For literally less than a dollar at a time, the customer gets a pain-free way to add to his savings.[7] These little nudges encourage those behaviors that Bank of America wants, like removing debit cards from ATM machines and making savings a routine activity.[8]

Default rules like these make certain decisions easier because the cost of bucking the rules often exceeds the benefit. Not everything lends itself to

3. If, say, a university wanted its football coaches to make sure that most of their players graduated on time, then perhaps the university might want to consider tweaking the amount of coach compensation that comes from bowl games and the amount that comes from graduation rates.

4. Sometimes I'm slow on the uptake.

5. It might not even be possible to input the password with the card still in the machine, because of the "spit-out" feature that Bank of America has created. A person puts his card in; the machine spits it out; he enters his password.

6. BANK OF AM., KEEP THE CHANGE SAVINGS PROGRAM, https://www.bankofamerica.com/deposits/manage/keep-the-change.go (last visited Jan. 24, 2014). So, if someone enrolled in the program buys something that costs $9.53, the debit card rounds that purchase up to $10 and deposits the difference ($0.47) into his savings account.

7. Other banks are probably doing (or will be doing) these types of programs as well.

8. Jennifer Robbennolt and Jean Sternlight refer to these "relatively minor changes in the relevant situation that can have a significant influence on behavior by leading, or 'channeling,' people in a particular direction" as "channel factors." JENNIFER K. ROBBENNOLT & JEAN R. STERNLIGHT, PSYCHOLOGY FOR LAWYERS: UNDERSTANDING THE HUMAN FACTORS IN NEGOTIATION, LITIGATION, AND DECISION MAKING 136–38 (2012).

default rules and low-stakes incentives, but why couldn't we use default rules and incentives to encourage certain behavior inside law firms?

I. CULTURE AND BEHAVIOR IN LAW FIRMS, AS REFLECTED BY DEFAULT RULES AND INCENTIVES

Just as "[h]appy families are all alike; every unhappy family is unhappy in its own way,"[9] law firms have developed their own cultures and norms. The successful[10] ones seem to have a lot in common; the failure of others can often be traced to singularly bad decisions.[11] And yet, even those "happy" law firms have differences, as anyone who has worked in more than one law firm can tell you. Virtually everyone in a successful law firm[12] is a hard worker, with significant talent in a variety of skills—analysis, writing, client relationships, strategy, and so on. But some firms have hallways in which the office doors are typically open for some schmoozing, and others have hallways in which pretty much every door stays shut. Some firms are relatively egalitarian; others aren't.

Still, even the happiest law firms are sweating bullets these days. BigLaw,[13] especially, is changing.[14] Clients are putting more and more

9. LEO TOLSTOY, ANNA KARENINA 1 (Barnes & Noble Classics 2003).

10. Or at least those whose mistakes haven't caught up to them yet—publicly.

11. Dewey & LeBeouf comes to mind. One of the reasons that it seems to have failed is that it guaranteed large draws to partners whose books of business couldn't support such high amounts. *See* James B. Stewart, *The Collapse: How a Top Legal Firm Destroyed Itself*, NEW YORKER 80, 87–89 (Oct. 14, 2013) [hereinafter *The Collapse*] (discussing the downfall of Dewey & LeBoeuf after its merger); *see also* Martha Neil, *Ex-Partner Blames Legal Recruiters, Excessive Pay Guarantees, Angry Colleagues for Dewey's Downfall*, A.B.A. J. (May 10, 2012, 3:12 PM) http://www.abajournal.com/news/article/former_partner_blames_legal_recruiters_excessive_pay_guarantees_for_dewey/ (looking at the alleged causes of Dewey & LeBoeuf's financial failure); Peter Lattman, *Dewey & LeBoeuf Files for Bankruptcy*, N.Y. TIMES (May 28, 2012, 10:21 PM), http://dealbook.nytimes.com/2012/05/28/dewey-leboeuf-files-for-bankruptcy/ (examining Dewey & LeBoeuf's bankruptcy).

12. And many of those at unsuccessful firms.

13. "BigLaw" has many definitions, see, for example, Noam Scheiber, *The Last Days of Big Law*, NEW REPUBLIC (July 21, 2013), http://www.newrepublic.com/article/113941/big-law-firms-trouble-when-money-dries ("There are currently between 150 and 250 firms in the United States that can claim membership in the club known as Big Law, the group of historically profitable firms that cater to the country's largest corporations."), but I'm using the phrase in a more generic and fuzzy sense; firms that have more than one or two offices, more than one or two practice areas, and a long list of notable clients with deep pockets.

14. When the general counsel of eighty-eight big companies were asked, "[a]re you more or less likely to use a good lawyer at a pedigreed firm (e.g., AmLaw 20 or Magic Circle) or a good lawyer at a non-pedigreed firm for high stakes (though not necessarily bet-the-company work), assuming a 30%

demands on their law firms[15] but are agreeing to pay for fewer and fewer services.[16] Those clients are also getting more sophisticated about reading their lawyers' bills.[17] Law firms need to change to cope with the

difference in overall cost?," 74% of the respondents said that they were less likely to use the pedigreed firm, 13% said that they'd choose the pedigreed firm, and 13% didn't choose one over the other. Dina Wang & Firoz Dattu, *Why Law Firm Pedigree May Be a Thing of the Past*, HBR BLOG NETWORK (Oct. 11, 2013, 2:10 PM), http://blogs.hbr.org/2013/10/why-law-firm-pedigree-may-be-a-thing-of-the-past/. I think that the days of general counsel choosing "name brand" BigLaw firms for every type of engagement are long gone.

15. For an eye-opening report on what Chief Legal Counsel care about, see ALTMAN WEIL, INC., 2013 CHIEF LEGAL OFFICER SURVEY, *available at* http://www.altmanweil.com/dir_docs/resource/4d12f27b-5e52-46b3-8a706372f360a85c_document.pdf.

16. *See* William D. Henderson, *A Blueprint for Change*, 40 PEPP. L. REV. 461, 461–62 (2013) (examining the saturated legal market); Bernard A. Burk & David McGowan, *Big But Brittle: Economic Perspectives on the Future of the Law Firm in the New Economy*, 2011 COLUM. BUS. L. REV. 1, 92 (2011) (analyzing the historical growth pattern of law firms). As one recent story reports: "I met last week with the head of legal operations for a top-five bank (also one of the biggest clients in the world) who is publishing updated billing guidelines that decline to pay for first- and second-year associates." Paul Lippe, *Yale Law Prof Falls Short in Challenging Obama's 2-year JD Idea*, A.B.A. J. (Sept. 11, 2013, 4:53 PM), http://www.abajournal.com/legalrebels/article/Profs_op-ed_opposing_a_twoyear_jd/ ?utm_source=maestro&utm_medium=email&utm_campaign=daily_email.

Certainly, though, some BigLaw firms are taking their associate training to a new level in response to client pressure about using junior associates on matters, even as the financial pressures on firms make training a more expensive proposition. For example, Skadden has partnered with the Fullbridge Program for its associate training. THE FULLBRIDGE PROGRAM, https://fullbridge.com/law/ (last visited Jan. 24, 2014). As Jodie Garfinkel at the firm has explained to me:

> Skadden has partnered with Fullbridge to ensure that its newest associates understand[] business and financial concepts. It combines that training with its own in-house training so that its newest associates are as comfortable with the concept[] of how to read balance sheets as they are with the substantive law in their practice areas. [Skadden associates] train across practice areas to ensure a more fulsome understanding of the Firm's practice. Associates who are conversant in the business world and who understand the range of legal issues facing clients . . . provide better value to their clients. In addition to this new training, to ensure attorneys are prepared to deal with increasing responsibility, Skadden provides training throughout their . . . time at the Firm.

E-mail from Jodie Garfinkel to author (Nov. 20, 2013, 02:38 PM) (on file with author). Milbank also has developed a partnership to train more senior associates: its program is called Milbank@Harvard. *Milbank@Harvard To Launch This Fall*, MILBANK (Aug. 11, 2011) http://www.milbank.com/news/milbank-harvard-to-launch-this-fall.html (last visited Jan. 9, 2014). These types of programs cut against the "common knowledge" that large firms aren't training their associates.

17. My buddy Dustin Benham has pointed me to Casey Flaherty's work in getting his outside counsel to demonstrate that they understand certain basic timesaving technology. *See*, *e.g.*, D. Casey Flaherty, *Could You Pass This In-House Counsel's Tech Test? If the Answer Is No, You May Be Losing Business*, A.B.A. J., LEGAL REBELS BLOG (July 17, 2013, 7:30 AM), http://www.abajournal.com/legalrebels/article/could_you_pass_this_in-house_counsels_tech_test ("I do not have the data or rigor to quantify just how much waste exists in the legal system or what percentage of it is attributable to

increasing demands of clients—but to change on an organizational level, they'll have to change the behavior of those who work there, and changing behavior is no easy feat.

I first started thinking about ways to change lawyer behavior because of my work as a fee examiner in some large Chapter 11 cases. With that work has come the opportunity to study lawyer behavior as it's reflected through the voluminous bills submitted for payment from bankruptcy estate funds. Based on those experiences, as well as my research on Enron and other corporate scandals,[18] my conversations with friends at several firms, and my own (admittedly now ancient) experience as a lawyer in a large law firm, I've formed some tentative conclusions about the effect of incentives in the workplace. On the theory that lawyers are, in fact, also sentient beings,[19] I've decided that the best way to regulate lawyer behavior is to pay attention to the natural human tendency to conform to default rules and incentives. By altering certain default rules and incentives in firms, firms can "nudge" changes in the behavior of everyone from lawyers to paralegals to support staff.[20] Rules and incentives regarding such things as when and how billable hours get recorded, how lawyers in practice groups cross-sell the firm's services, and how newer lawyers get

technological incompetence. My claims are much broader: *a lot* (of waste exists in the legal system) and *enough* (of that waste is attributable to technological incompetence to make this a problem worth addressing.")).

18. NANCY B. RAPOPORT, JEFFREY D. VAN NIEL & BALA G. DHARAN, ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER (Foundation Press 2d ed. 2009); NANCY B. RAPOPORT & BALA G. DHARAN, ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (2004); Nancy B. Rapoport, *The Real Reason Why Businesses Make Bad Decisions*, BUS. LAW TODAY, July/Aug. 2009, at 52 (reviewing JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN (Princeton University Press 2008)); Nancy B. Rapoport, *Lessons From Enron—And Why We Don't Learn from Them*, COM. LENDING REV., May–June 2009, at 21; Colin Marks & Nancy B. Rapoport, *Corporate Ethical Responsibility and the Lawyer's Role in a Contemporary Democracy*, 77 FORDHAM L. REV. 1269 (2009); Nancy B. Rapoport, *The Curious Incident of the Law Firm That Did Nothing in the Night-Time*, 10 LEGAL ETHICS 98 (2007) (reviewing MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER (Univ. of Michigan Press 2004)); Nancy B. Rapoport, *Enron, Titanic, and the Perfect Storm*, 71 FORDHAM L. REV. 1373 (2003) (appearing also as an essay in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 927 (2004)).

19. Notwithstanding the theme of most jokes about lawyers.

20. Of course, as my buddy Walter Effross has pointed out to me, lawyers are trained both to detect and to consider ways to work around default rules. E-mail and attachment from Walter Effross to author (Sept. 20, 2013, 03:58 PM) (on file with author).

trained are all examples of how developing the right incentives and default rules can make a firm behave in more efficient, ethical, and possibly more profitable ways.

I chose the word "nudge" in this article's title deliberately, and not just because I like its double entendre of "push" and "nag."[21] In *Nudge: Improving Decisions About Health, Wealth, and Happiness*, Richard Thaler and Cass Sunstein use basic principles of behavioral economics to describe how incentives—including default rules that let people "opt in" and "opt out" of certain behaviors—can change those behaviors over time.[22] The "nudge" concept involves tweaking an incentive or default rule to shape behavior, rather than making sudden and drastic changes.[23] My hypothesis is that, by doing some tweaking, firms can nudge[24] their people to engage in those behaviors that will better serve clients in the long run.[25]

Lawyers who are in charge of their firms are supposed to monitor the ethical behavior of those who work there.[26] They're supposed to make sure that client confidences stay protected, conflicts are avoided, fees are reasonable, and people are working competently and diligently.[27] Like

21. *See* MERRIAM-WEBSTER'S NEW COLLEGIATE DICTIONARY 797 (10th ed. 1997) (defining "nudge" as "to touch or push gently" or "to prod lightly : urge into action").

22. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 83–87 (2009).

23. If Mayor Bloomberg had tried a less drastic method of getting people to drink fewer sodas—such as by having a graduated tax on larger sizes, rather than an outright ban on large cups—there might have been a less vituperative reaction to his edict. *See* Chris Dolmetsch & Henry Goldman, *New York Soda Size Limit Statute Barred by State Judge*, BLOOMBERG.COM (Mar. 11, 2013, 3:30 PM), http://www.bloomberg.com/news/2013-03-11/new-york-city-soda-size-limitations-barred-by-state-court-judge.html (discussing the Bloomberg soda issue); *see also infra* notes 115–16 and accompanying text.

24. "Nudge" may be an understatement with some of my proposals here, especially as they relate to changing incentives or default rules regarding compensation. Any changes to compensation incentives will be a big deal—not a subtle, "nudge" type of event. At most places (including most law firms), compensation issues are analyzed in elaborate detail.

25. Theoretically, better service to clients in the long run should also benefit the firm.

26. *See* MODEL RULE OF PROF'L CONDUCT R. 5.1(a) (2013) ("A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.").

27. And in some circumstances, not following rules in specific matters can cost law firms money. For example, in large Chapter 11 cases, the new U.S. Trustee Guidelines are very specific about such rules as billing time in tenths of hours. *See* U.S. DEP'T OF JUSTICE, FEE GUIDELINES, APPENDIX B–GUIDELINES FOR REVIEWING APPLICATIONS FOR COMPENSATION AND REIMBURSEMENT OF EXPENSES FILED UNDER 11 U.S.C. § 330 FOR ATTORNEYS IN LARGER CHAPTER 11 CASES, at 1, 17 (2013), http://www.justice.gov/ust/eo/rules_regulations/guidelines/docs/Fee_Guidelines.pdf (requiring that time be kept "in increments of no more than one tenth (.1)

any other type of organization, a law firm will have rules for each of these ethical principles.[28] But having rules in place isn't nearly as important as having the *right* rules in place. Every business that has failed, with its C-level officers indicted or sued, has had rules. The real incentives, though, cut against following those rules.[29]

That's why it's important to figure out what the *actual* default rules and incentives are in any law firm, rather than focusing upon the "official" rules in that firm.[30] I'm not convinced that we'll always isolate the correct incentives to trigger ethical behavior, because finding the precisely correct incentives is an exceptionally difficult undertaking. But we should try. Otherwise, the types of behaviors that underlie some of the major changes occurring in modern U.S. BigLaw practice—a move toward outsourcing certain types of legal tasks,[31] more client pressure on bills, a (slight) move away from billing by the hour, the demise of some high-powered law firms,[32] the merging of others,[33] and the downsizing of yet more[34]—will

of an hour"). Firms whose professionals "block-bill" are subject to objections by the United States Trustee regarding the reasonableness of their fees. Whether the bankruptcy courts sustain those objections for failure to follow the Guidelines remains to be seen.

28. And as my buddy Randy Gordon has pointed out to me, malpractice insurers take great pains to get law firms to comply with the ethics rules. E-mail from Randy Gordon to author (Sept. 23, 2013, 01:11 PM) (on file with author).

29. To beat a particularly beloved dead horse of mine, take Enron. Enron had a code of ethics that specified that its employees followed the "R-I-C-E" model of respect, integrity, communication, and excellence. But Enron's incentives encouraged disrespect, lying, hiding the ball, and seriously dumb deals. Nancy B. Rapoport, *Lessons From Enron—And Why We Don't Learn from Them*, COM. LENDING REV. May–June 2009, at 21, 21.

30. My buddy Walter Effross reminded me that the difference between official rules and actual rules is like the difference between an organizational chart and the actual "who's doing what" within an organization. *See* notes on earlier draft from Walter Effross to author (Sept. 20, 2013) (on file with author) (analyzing rules and management within a law firm); *see also* LEE G. BOLMAN & TERRENCE E. DEAL, REFRAMING ORGANIZATIONS: ARTISTRY, CHOICE, AND LEADERSHIP 43–116, 189–246 (4th ed. 2008) (discussing the structural and political "frames").

31. *See, e.g.*, K. William Gibson, *Outsourcing Legal Services Abroad*, L. PRAC. MAG., July/Aug. 2008, at 47, 48–49 *available at* http://www.americanbar.org/publications/law_practice_home/law_practice_archive/lpm_magazine_articles_v34_is5_pg47.html (describing legal market outsourcing).

32. *See* L. SHUCKS, http://lawshucks.com/biglaw-dead-pool/ (last visited Jan. 24, 2013) (listing a running tally of dead BigLaw firms).

33. On October 25, 2013, the merger discussions between two very large firms, Pillsbury Winthrop Shaw Pittman and Orrick, Herrington & Sutcliffe, hit the national news. *See, e.g.*, Peter Lattman, *Law Firms Orrick & Pillsbury in Merger Talks*, N.Y. TIMES (Oct. 25, 2013, 4:02 PM), http://dealbook.nytimes.com/2013/10/25/law-firms-orrick-and-pillsbury-in-merger-talks/?_r=0

make practicing in a BigLaw environment an increasingly risky proposition.[35] To illustrate some of the stresses that law firms are experiencing, I'm going to draw from my own experiences at a BigLaw firm and from some stories about other BigLaw firms.[36] I'm focusing on BigLaw firms because that's also the focus of most of the national news about changes in law practice, although my observations will apply to some non-BigLaw practices as well.[37]

Let's start with an old-fashioned tale about law firm incentives in the 1980s. When I worked at a BigLaw firm, a few of our lawyers were late in submitting their billable time to the accounting department. By "late," I mean several weeks late. Submitting late timesheets[38] created two serious problems: first, without a record of billable hours, billing partners[39] couldn't send timely and complete bills to their clients; second, without making a contemporaneous record of what a lawyer had spent his or her time doing, developing those detailed records was an ethically risky proposition. There may have been some lawyers who could think back several weeks and belatedly record their work down to small slices of an hour, but they would have needed a superhuman memory to have done so accurately. Either they underestimated their work, or they overestimated it. The pressure to bill at least 1,800 (or 2,200, or 2,600, or more) hours a year likely meant that the scale of "filling in the blanks" created at least a

("[The] combination would create one of the country's 10 largest firms, with about 1,700 lawyers."). That particular merger cratered. *See* Jennifer Smith, *Orrick-Pillsbury Merger Talks Are Off* (Nov. 25, 2013, 3:12 PM), http://blogs.wsj.com/law/2013/11/25/orrick-pillsbury-merger-talks-are-off/.

34. The extreme lateral mobility that some partners have enjoyed, thanks to their robust "books of business" (clients who will follow them), has added to law firm bottom-line uncertainty.

35. The more that lawyers in firms feel that their business model is threatened, the more likely it is that some of them will panic and accede to client demands that might not necessarily be ethical in order to keep the client's business. The more pressure that lawyers face, then, the more we need to come up with structures to counteract any improper survival strategies.

36. My source at a very good midsize firm paints a very different picture of what his firm does with respect to compensation, bonuses, circulating information about colleagues' pay and activities, and policies about billing. At his firm, the interoffice conference time gets written off as benefitting the firm more than the client, although the underlying activities that come out of those conferences do get billed to the client.

37. My ideas might not translate well to firms with certain types of practices, such as criminal defense work, as my buddy Doug Berman pointed out to me when I presented this paper at Ohio State.

38. Late-submitted timesheets may still represent contemporaneously recorded time that simply hasn't been turned over to the billing department yet; late-recorded time, on the other hand, is a more serious problem.

39. Or shareholder.

subconscious incentive to overestimate the time spent on a given task.

Back when many of us received our (hard-copy) paychecks in envelopes, the managing partner tried to change the habits of those who turned in late timesheets by making the scofflaws pick up their checks in his office. I'm reasonably certain that the long march to the managing partner's office, though, didn't change the behavior of any inveterate late-billers—at least those who had figured out how not to live paycheck-to-paycheck. The "long march" might have spurred some occasional late-billers to learn to record their time contemporaneously, but the fact that the long march policy didn't disappear after a few weeks suggests that the policy didn't change much behavior.[40]

Take another late-1980s example: bonuses. We associates made good salaries, but at some point in my career, the firm decided to award yearly bonuses of several thousand dollars for associates who billed significantly more time than the minimum yearly billable requirement. (I seem to recall that the minimum yearly requirement was around 1,800 or 1,900 hours a year, although I only knew a handful of friends who billed fewer than 2,300 or 2,400 hours a year.) On the theory that people preferred more money to less money, the firm used bonuses to encourage us to work even harder.

There were three problems with the incentive of bonus payments. First, it equated "more hours" with "more hours that were valuable to the firm (and the client)." Unfortunately, not every billable hour is created equal. Inefficient time billed by the hour drains away value to the client, and exhausted lawyers often work inefficiently.[41] In other words, what the firm was measuring (hours) didn't necessarily reflect the underlying goal of

40. My husband has pointed out that one of his law firms also had a "no timesheet, no pay" policy, and he's not sure that his firm's policy worked, either. Other firms fine lawyers for late timesheets by deducting a certain amount from their salaries, but the point's the same—some people will change their behavior because of the operant conditioning that comes from fines and penalties, and others will keep on submitting late timesheets unless we find structural ways to make it almost impossible for them to *be* late. *Cf. infra* notes 146–57 and accompanying text.

41. Moreover, it's more likely that tired lawyers make all sorts of mistakes, including ethical ones. *See, e.g.*, MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 34 (2011) ("[D]ecision making tends to be most ethically compromised when our minds are overloaded. The busier you are at work, for example, the less likely you will be to notice when a colleague cuts ethical corners or when you yourself go over the line.").

doing more high-quality and valuable work. The more slowly that a lawyer worked, the more billable hours he or she would rack up, and the closer that lawyer would be to a bonus. Second (even if a lawyer ignored the temptation to work slowly),[42] the proffered bonus still created perverse incentives. A lawyer might work twenty more billable hours one month if that extra work might result in moving from one bonus level to a higher bonus level. But that same lawyer might not be as excited about working those twenty extra billable hours if he or she was, say, 300 hours away from the next bonus level. The relationship of lawyer-to-billable-treadmill was by no means a straight line. Finally, for those lawyers who valued leisure time more than money, bonuses provided no incentive at all.[43]

We associates weren't unique in terms of adjusting to our firm's incentives.[44] People play to the incentives that they're given. Those incentives might be more money in one's paycheck, or a higher standing in the community, or the trust and love of our friends and family. The trick, as every manager of every business knows, lies in creating the types of incentives that reward the behavior that you want while discouraging the behavior that you don't want. Therefore, if we want to sharpen the force of the rules that we intend to put in place, then we need to think about how incentives and default rules play into human behavior.

A recent story about one very good law firm illustrates this point. In *The New Republic*, Noam Scheiber described how Mayer Brown tried to change some incentives to encourage its partners to increase the amount of business coming in:

42. And let's not pretend that the temptation to work more slowly, or do more work on a project than is reasonably necessary, isn't there. It is. The question is whether a lawyer yields to that temptation or even acknowledges the temptation in the first place. It's possible that a lawyer might nitpick and rewrite a draft to death not because she wants the hours but because she doesn't want to let go of a draft that isn't perfect—but it's also possible that, in the deep recesses of her mind—she knows that taking the extra time means extra fees.

43. *See Leaning Out: The 2013 Associate[s'] Survey*, THE AM. LAW., Sept. 1, 2013, *available at* http://www.americanlawyer.com/PubArticleTAL.jsp?id=1202512392833&amp%3bThe_Associates_Survey&slreturn=20131128140543 (survey involving trading billable hours requirement for a portion of salary). Hat tip to Walter Effross for that one. When bonuses to associates first became trendy, I recall one of my friends saying, probably around October, that he had hit his 1,800 hours for the year and had decided to take the rest of the year off.

44. As my colleague Jean Sternlight pointed out on an earlier draft of this article, though, "[p]sychologists believe that there is lots going on beneath the surface so that incentives might not be as powerful as one might assume." Notes on earlier draft from Jean Sternlight to author (Sept. 20, 2013) (on file with author). She's right. Pure incentives will never tell the whole story. People's cognitive errors and biases will always factor in.

> For decades prior to the 1980s, Mayer Brown tilted in the lockstep direction. But, after the collapse of Continental, Bob Helman realized the firm would go under if his partners sat around waiting for business to walk in the door. Hereafter, he decreed, each partner's compensation would depend heavily on the amount of business he or she drummed up.
>
> Helman's plan may have worked too well. Ever since it went into effect, partners have competed aggressively not just against lawyers at other firms, but against one another. Chicago partners would fly into New York to poach clients from their Manhattanite counterparts, holding clandestine meetings in which they would pitch themselves as less expensive and a mere two-hour plane ride away. When the New Yorkers invariably caught wind of these plots, they would remind clients that they were far more efficient than their Midwestern cousins. 'What we would end up saying is . . . "Chicago will staff you with four partners on something we'd staff with one or two,'" recalls a former partner. 'It's crazy that I have to go in and have a conversation about it. Denigrating.' (The problem has been somewhat mitigated in recent years by more formal firm-wide 'client teams,' though many still complain about the struggle to be included.)[45]

The straightforward link of problem ("we need to bring in more business") to solution ("if partners get more money from whatever business they bring in, they're more likely to hustle for more business") was logical, but it had some unfortunate unintended consequences.[46] So did some of the

45. Noam Scheiber, *The Last Days of Big Law: You Can't Imagine the Terror When the Money Dries Up*, NEW REPUBLIC (July 21, 2013), http://www.newrepublic.com/article/113941/big-law-firms-trouble-when-money-dries (footnote omitted).

46. Mayer Brown isn't the only firm that has struggled with this issue. In the book *Turks and Brahmins: Upheaval at Milbank, Tweed*, Ellen Pollock describes the initial pushback of some partners to the idea that the firm should change its lockstep compensation:

> Lockstep compensation allowed partners to focus on serving their clients instead of amassing power. . . . [Partner Norman Nelson] painted a picture of life without lockstep, a world with squabbling partners, unbridled quests for power, and partners deserting the firm solely for more lucrative opportunities. In short, money ruled and, as Nelson reminded the quiet group before him, quarrels over money inevitably brought out the worst in people.

ELLEN JOAN POLLOCK, TURKS AND BRAHMINS: UPHEAVAL AT MILBANK, TWEED 201 (1990). Over the Thanksgiving holiday, I spoke with a partner at Clifford Chance who explained why the firm has stayed with lockstep compensation—the rationale was the same. The gradation of distinctions across a variety of talented people didn't seem to be worth the candle. The tradeoff is, of course, between having money represent an anchor point for measuring where a person is in the pecking order and engendering resentment if some people aren't pulling their weight.

firm's other initiatives, such as disclosing to all partners how many points each partner was getting:

> In practice, settling on compensation for partners at Mayer Brown, as at many firms, is an elaborate ritual that runs through the first two months of each year and includes a remarkable amount of special pleading by way of memos and personal interviews. Finally, in late February, the management committee hands down the "points list," Ten Commandments–style, enumerating what share of the firm's profits each partner is entitled to. In a typical year, each "point" might be worth $3,000, so that someone who received 500 points would take home $1.5 million. (The firm may also award a bonus on top of this amount.)
>
> Unlike most other firms, Mayer Brown then introduces a final wrinkle: The points list is disclosed for all to see. Since each partner aspires to be among the 50 who make the first page, where the highest earners appear, the amount of resentment this engenders is hard to overstate.[47]

Circulating how may points each partner was going to receive is akin to circulating the monthly or yearly billable hours of each law firm employee. Intentional circulation of such information is designed in part to spur competition, and it clarifies the pecking order. (I don't know if the Mayer Brown pecking order is based just on the partners' realization rate, or on how powerful each partner's clients are, or on some other metric or combination of metrics.) Of course, the reverse would also be true: if every partner took home the exact same amount, then some partners would feel that their extra efforts were unappreciated. Moreover, if the firm gave its associates no clue as to how well it was matching budgeted income to actual income (which is the ultimate point of circulating billable hour information),[48] then the associates wouldn't have a sense of how busy everyone was each month.[49] There's no clear right or wrong decision about disseminating information like this.[50] The point, though, is that

47. ELLEN JOAN POLLOCK, TURKS AND BRAHMINS: UPHEAVAL AT MILBANK, TWEED 201 (1990).

48. I also think the reason that firms include everyone's monthly billable hours relates to the fact that firms hire a lot of type A people who like to measure themselves against their peers. The people in law firms who went around faux-complaining about how hard they were working were likely the same people who went around to their first-year classmates talking about their LSAT scores.

49. Savvy lawyers know, though: it's not the billables that matter. It's the realization rate—of those hours that are actually billed to the client, how many will the client be willing to pay?

50. Dustin Benham has pointed out to me two advantages of circulating everyone's hours to everyone else: it makes overinflated hours more difficult to hide (although the issue of whether anyone will point out overinflated hours depends in part on the "diffusion of responsibility"

how a firm chooses to disseminate information, and what information it chooses to disseminate, sends powerful signals to everyone at the firm about the firm's core values. It also helps people within the firm learn what levers to push to get more rewards:

> The new [points] system was supposed to eliminate the brutal internal competition for credit and the frenzied haggling during compensation season. 'It was very clearly explained to people that, when you're in a band, you're probably in it for two-to-three years,' recalls a former partner on the firm's management committee. 'If you had a great onetime year, you'd get a bonus. . . . But you're not going to move a band because of one change.' It didn't pan out that way. 'Practice leaders . . . would say, "Here are fifteen people who need to move a band,'" adds the partner. 'All hell broke loose.'
>
> Given that it is human nature to hoard in lean times, it didn't help that a recession was about to bear down on the firm. When the points sheet came out in February 2009, partners discovered that each point—the share of profits they were entitled to—was worth roughly [twenty] percent less than the previous year, a huge pay cut. The following February, the points were devalued by [ten] percent more. This in itself was understandable; the firm had been hit hard by the financial crisis. But when the partners looked more closely at the points list, they noticed something infuriating: A small

phenomenon), and it makes it hard for slackers to hide that they're not pulling their weight. E-mail from Dustin Benham to author (Oct. 10, 2013, 01:31 PM) (on file with author). One major law firm uses a more complex way of measuring how the firm is doing, via something called a "financial dashboard":

> Attorneys could also access on their computers a tool known as the financial dashboard. Some used it daily. The dashboard showed numbers such as accounts receivable by bucket category and work time in progress. "It is much more real time than a monthly sheet," one partner noted. "It shows hours, time value, unbilled time, fees collected. All those reports are drillable by client." Tracking daily metrics gave attorneys a granular understanding of their own profitability and the state of the firm. One practice group head said he spent one day each month managing bills for his practice through the dashboard.

Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 9 (July 26, 2013). It seems to me that the difference between circulating everyone's monthly billable hours and circulating a financial dashboard is the difference between reporting a mean without a standard deviation and reporting both the mean and the standard deviation. The latter actually gives someone useful perspective. *See* Susan Wloszczyna, *George Carlin, 71, Questioned Authority and Made it Funny*, USA TODAY (June 24, 2008, 5:27 PM), http://usatoday30.usatoday.com/life/people/2008-06-23-carlin-obit_N.htm (quoting Carlin's classic bit about partial sports scores: "(As sportscaster 'Biff Burns'): 'Here is a partial score: Pittsburgh, 37.'").

minority of their colleagues had been made whole through bonuses.[51]

That excerpt makes an important point about default rules and incentives: if there's a perception that they're not being administered fairly, then the rank-and-file can get ornery.[52] At some point, those who believe that playing by the rules makes them chumps will get more aggressive about their demands, or they'll leave, or they'll become demoralized and, yes, less productive.[53] The challenge when running any organization (let alone one stuffed to the gills with brainy overachievers) is to find fair and rational ways to channel individual behavior so that what people want to do dovetails with what the organization needs them to do. But channeling human behavior is incredibly difficult to do well, even if one understands some of the common ways that humans tend to think and behave. And trying to channel human behavior without understanding human biases and thought processes is sheer folly.

II. SOME BASIC THOUGHTS ABOUT DEFAULT RULES AND INCENTIVES

At the individual level . . . we fall prey to psychological processes that bias our decisions—and, more importantly, we don't know they are biased.

51. Noam Scheiber, *The Last Days of Big Law: You Can't Imagine the Terror When the Money Dries Up*, NEW REPUBLIC (July 21, 2013), http://www.newrepublic.com/article/113941/big-law-firms-trouble-when-money-dries (footnote omitted).

52. *See* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 308 (2011) ("Employers who violate rules of fairness are punished by reduced productivity . . . ."); *see also* Scott Killingsworth, *Modeling the Message: Communicating Compliance Through Organizational Values and Culture*, 25 GEO. J. LEGAL ETHICS 961, 975 (2012) ("A company's authority is considered legitimate only to the extent that the organization is perceived as being ethical and fair in its interactions with employees and third parties.").

53. As Noam Scheiber noted:

> Some of the beneficiaries were major business generators. As 2008 wore on, many of these big shots had eyed the exits and a few began to leave. "Rich Morvillo"—a prominent white-collar criminal defense lawyer—"said, 'I don't want to be the last man standing in D.C. If there's going to be an exodus, I'm going to be part of that,'" recalls one former partner. Meanwhile, others simply let it be known that they were out the door unless the firm opened its wallet—"the table-pounders," as some called them. While the logic of appeasing them was self-evident, the message it sent was terrible. "There was a sense among many of us at the time that the firm had in good faith been trying to move from eat-what-you-kill to a more collectivist culture," recalls one former partner. "It was a serious backtrack—punishing partners who had been playing by the rules."

Noam Scheiber, *The Last Days of Big Law: You Can't Imagine the Terror When the Money Dries Up*, NEW REPUBLIC (July 21, 2013), http://www.newrepublic.com/article/113941/big-law-firms-trouble-when-money-dries (footnote omitted).

> *At the organizational level, business leaders typically fail to appreciate the role of bounded ethicality in their employees' decisions. Furthermore, they typically believe that their employees' integrity will protect them and the organization from ethical infractions. Yet many ethical infractions are rooted in the intricacies of human psychology rather than integrity. To design wise interventions, leaders need to consider the ways in which their current environment could prompt unethical action without the decision maker's conscious awareness.*[54]

A. *A Bit About Human Biases*

Just as so many others have,[55] I've written about the intersection of cognitive errors with lawyer decision-making.[56] The fact is that we all

54. MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 21 (2011).

55. JENNIFER ROBBENNOLT & JEAN STERNLIGHT, PSYCHOLOGY FOR LAWYERS: UNDERSTANDING THE HUMAN FACTORS IN NEGOTIATION, LITIGATION AND DECISION MAKING, (ABA 2013); RANDALL KISER MARTIN, BEYOND RIGHT AND WRONG: THE POWER OF EFFECTIVE DECISION MAKING FOR ATTORNEYS AND CLIENTS (2009); PSYCHOLOGICAL PERSPECTIVES ON ETHICAL BEHAVIOR AND DECISION MAKING (David de Cremer ed. 2009); PSYCHOLOGY AND LAW: AN EMPIRICAL PERSPECTIVE (Neil Brewer and Kipling D. Williams eds., 2005); Richard Birke & Craig R. Fox, *Psychological Principles in Negotiation Civil Settlements*, 4 HARV. NEGOT. L. REV. 1 (1999); John M.D. DiPippa, *How Prospect Theory Can Improve Legal Counseling*, 24 U. ARK. LITTLE ROCK L. REV. 81 (2001); Chris Guthrie, *Panacea or Pandora's Box? The Costs of Options in Negotiations*, 88 IOWA L. REV. 601 (2003); Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163 (2000); Chris Guthrie, *Better Settle Than Sorry: The Regret Aversion Theory of Litigation Behavior*, 1999 U. ILL. L. REV. 43; Russell Korobkin, *Psychological Impediments to Mediation Success: Theory and Practice*, 21 OHIO STATE J. DISP. RESOL. 281 (2006); Russell Korobkin & Chris Guthrie, *Psychology, Economics and Settlement: A New Look at the Role of the Lawyer*, 76 TEX. L. REV. 77 (1997); Russell Korobkin and Chris Guthrie, *Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107 (1994); Martine B. Powell & Rebecca B. Wright, *Professionals' Perceptions of Electronically Recorded Interviews with Vulnerable Witnesses*, 21 CURRENT ISSUES CRIM. JUST. 205 (2009); Martine B. Powell, *Specialist Training in Investigative and Evidential Interviewing: Is It Having Any Effect on the Behaviour of Professionals in the Field*, 9 PSYCHIATRY PSYCHOL. & L. 44 (2002); Jeffrey J. Rachlinski, *A Positive Psychological Theory of the Value of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998); Jean R. Sternlight, *Lawyer's Representation of Clients in Mediation: Using Economics and Psychology to Structure Advocacy in a Nonadversarial Setting*, 14 OHIO STATE J. ON DISP. RESOLUTION 269 (1999).

56. Nancy B. Rapoport, *The Client Who Did Too Much*, 47 AKRON L. REV. 121 (2014); Nancy B. Rapoport, *Rethinking U.S. Legal Education: No More "Same Old, Same Old"*, 45 CONN. L. REV. 1409 (2013); Nancy B. Rapoport, *Managing U.S. News & World Report—The Enron Way*, 42 GONZAGA L. REV. 423 (2013); Nancy B. Rapoport, *The Case for Value Billing in Chapter 11*, 7 J. BUS. & TECH. L. 117 (2012); Nancy B. Rapoport, *Changing the Modal Law School: Rethinking U.S.*

have the potential to be fooled by a variety of unconscious biases and misguided thinking. We might justify our serious misbehavior by rationalizing it with our perception that, as good people, we didn't do anything wrong (cognitive dissonance).[57] We might stay silent about something that's obviously wrong because we assume that someone else who knows about that problem will deal with it (diffusion of responsibility).[58] We might shape our behavior or opinions to conform to those of our peers, even though our own senses disagree with what our peers are saying and doing (social pressure).[59] We might tend to focus on one particular factor while ignoring all other information (anchoring).[60] And thanks to the fact that we're human, we might be experiencing some or all of these[61] cognitive errors simultaneously.

Smart and well-educated people are still subject to the same spate of cognitive errors that the less fortunate experience. Let's take the example of Dewey & LeBeouf's demise. Dewey & LeBeouf was chock-full of smart

Legal Education in (Most) Schools, 116 PENN ST. L. REV. 1119 (2012); Nancy B. Rapoport, *Through Gritted Teeth and Clenched Jaw: Court-Initiated Sanctions Opinions in Bankruptcy Courts*, 41 ST. MARY'S L.J. 701 (2010); Nancy B. Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, 5 J. BUS. & TECH. L. 263 (2010); Nancy B. Rapoport, *The Curious Incident of the Law Firm That Did Nothing in the Night-Time*, 10 LEGAL ETHICS 98 (2007) (reviewing MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER (Univ. of Michigan Press 2004)); Nancy B. Rapoport, *Enron, Titanic, and the Perfect Storm*, 71 FORDHAM L. REV. 1373 (2003); Nancy B. Rapoport, *The Real Reason Why Businesses Make Bad Decisions*, BUS. LAW TODAY, July/Aug. 2009 at 52 (reviewing JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN (Princeton University Press 2008)).

57. *See* Saul McLeod, *Cognitive Dissonance*, SIMPLYPSYCHOLOGY (2008), *available at* http://www.simplypsychology.org/cognitive-dissonance.html (describing cognitive dissonance in layperson terms).

58. *See, e.g.*, Noam Shpancer, *Bystanders and Heroes: The Dance of Defiance and Conformity*, PSYCHOLOGY TODAY (Dec. 26, 2012), *available at* http://www.psychologytoday.com/blog/insight-therapy/201212/bystanders-and-heroes-the-dance-defiance-and-conformity (providing examples of how the "bystander effect" can affect a person's behavior).

59. *See, e.g.*, Saul McLeod, *Asch Experiment* SIMPLYPSYCHOLOGY (2008), *available at* http://www.simplypsychology.org/asch-conformity.html (describing the procedure, results, and conclusions of Solomon Asch's experiment on human group conformity).

60. *See Anchoring Bias in Decision-making*, SCIENCE DAILY, http://www.sciencedaily.com/articles/a/anchoring.htm (last visited Jan. 24, 2014) (describing the tendency to "anchor" on a specific item); *see also Selective Attention Test*, YOUTUBE, http://www.youtube.com/watch?v=vJG698U2Mvo (last visited Jan. 24, 2014) (showing the classic test of how focusing on a specific item will cause the viewer to miss or disregard a person in a gorilla costume moving through a crowd) (sorry for the spoiler alert).

61. Or others as well. *See, e.g.*, *List of Cognitive Biases*, SCIENCE DAILY, http://www.sciencedaily.com/articles/l/list_of_cognitive_biases.htm (last visited Jan. 24, 2014) (listing and defining the various cognitive biases).

and well-educated people. James Stewart's version of what killed the firm[62] demonstrates how all four of these cognitive errors can play out.

Steven Davis, the head of LeBeouf, Lamb, Green & MacRae, had wanted to bring in Ralph Ferrara, a high-billing partner from another firm, in order to move LeBeouf up the law firm pecking order. Ferrara was only willing to move if he received a guaranteed draw that wasn't tied to his performance, as well as a signing bonus that would replace his pension at his current firm: a deal that involved a $16 million payout plus a guarantee of $1.6 million a year.[63] When Morton Pierce, the co-chair of Dewey Ballantine, later negotiated with Davis over the merger of their two firms, that sweetheart deal with Ferrara came back into focus. Pierce also wanted a sweetheart deal (and he got one, with a five-year contract consisting of an annual $5 million salary and a $1 million profit payout plus a $5 million signing bonus).[64] Other high-ticket contracts to retain key partners followed. If the merged firm had actually generated enough profits to pay everyone what their contracts said that they were owed, then Dewey & LeBeouf would likely still be around.[65] But the firm didn't make those kinds of profits,[66] and the firm went belly-up.

LeBeouf, Lamb's goal of becoming more prominent was reasonable.[67] But basic business sense says that, at best, the proposition of being willing to guarantee big bucks without reference to how much the "big bucks" recipient is contributing to the bottom line is very risky. So why was LeBeouf willing to go out on a limb? When a management committee runs an organization, there's a risk of both social pressure ("You don't *want* us to get better, you cheapskate, you?") and diffusion of responsibility ("I know that these contract guarantees are very expensive, but if they were totally out of whack, someone else on the management committee would

62. *See generally* James B. Stewart, *The Collapse: How a Top Legal Firm Destroyed Itself*, NEW YORKER 80 (Oct. 14, 2013) (explaining the downfall of Dewey & LeBeouf).

63. *Id.* at 82–83.

64. *Id.* at 87.

65. There's no per se reason why an "eat what you kill" compensation system has to be "bad" and a lockstep one "good." Every compensation system has plusses and minuses. It's how the system actually works, given the particular people and client base involved, that dictates whether the system is good or bad for the firm.

66. *Id.* at 89–93.

67. In some sense, "prominence" is bounded by the fact that the folks higher up on the pecking order rarely are willing to step aside to make room for those who want to move up.

have stopped me") kicking in. The entire idea of "let's get famous lawyers to join us so that we look as though we're moving up in the pecking order" is a classic anchoring error mistake. By watching who was coming aboard, the firm was missing how much each new lateral might cost the firm in the long run. And by exposing the firm to potentially large shortfalls, Steven Davis likely was dealing with cognitive dissonance ("I know that these deals are risky, but if our firm is to thrive, I should make these deals even though I know that there's a huge financial exposure and that the lawyers who don't get similar deals will be demoralized"). Very smart people ran LeBoeuf, Lamb, and very smart people ran Dewey Ballantine, but the point is that smart *people* ran those firms. People make cognitive errors, and the errors that we now see in the aftermath of the Dewey & LeBeouf death spiral are four of the most classic cognitive errors that exist.[68]

And yet, just like Ron Popeil's inventions,[69] there's more. We're capable of fooling ourselves in countless ways. We can, without realizing it, pick and choose what we remember in order to justify particular conclusions that we've reached (confirmation bias).[70] We can confuse

68. Compare how Dewey handled compensation and how Duane Morris says that it handles it. In addition to being exceptionally transparent about its calculations, Duane Morris emphasizes the need to stay within its budget:

> There are some personalities, when it comes to advising them of a downward adjustment in their compensation, where you simply have to be as direct as possible. I might say, for example, "Hey, you were at a number close to $800,000 last year, and frankly, this year your results were a bit off. We are in a situation where we need to spread some of this money out to other folks that are on an upswing… I'm going to have to ask you to take a $50,000 reduction, and here's why." I would likely go on to say to that lawyer: "You are an equity partner and last year enjoyed the fruits of our 14% over-budget results. We really need you to accept the reduction this year so that we can live within our budget." Sometimes these conversations are challenging, but in my experience we have always gotten through them well.

Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 11 (July 26, 2013); *see also infra* note 95 and accompanying text.

69. *See, e.g.*, *About Ronco*, RONCO.COM, https://www.ronco.com/aboutus.html (last visited Jan. 24, 2014) (detailing the history and inventions of Ron "Ronco" Popeil).

70. Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1155 (2013).

> *Confirmation bias* also helps us remember aspects of the decision or situation that are consistent with an ethical self-image, rather than the details of any ethical lapse. "If mistakes were made, memory helps us remember that they were made by someone else. If we were there, we were just innocent bystanders." Such memory effects can result in what ethicist Patricia Werhane has called *moral amnesia* or "an inability to remember past mistakes and to transfer that knowledge when fresh challenges arise."

getting a good result with having had a sound process for reaching that result (hindsight bias). Because we're human, we can fall into certain patterns of thinking and behaving that, viewed dispassionately, are flat-out wrong, embarrassing, or downright venal. And we can do so when we're well-rested and well-fed, not particularly stressed-out, and with plenty of time to think about what we're doing. Imagine what happens when lawyers work at the frenetic pace of modern practice.[71] In the tug-of-war between how psychologists view the world and how sociologists view it, there's plenty of "the person versus the situation" considerations to go around. We all have cognitive biases, and our individual situations put us in the position of having those biases do their work extremely well.

B. *Social Pressure*

Of particular interest to those running law firms is the effect of social pressure on a person's decision-making. For the same reason that parents want their children to play only with those friends whom the parents believe are "good influences," the behavior that law firms generate will depend a whole lot more on how the majority of people in the firm behave than on what a firm's policies and procedures manual says. To illustrate this point, Solomon Asch's experiments on social pressure are classics, and his own description of their format is worth reading:

> A group of seven to nine young men, all college students, are assembled in a classroom for a "psychological experiment" in visual judgment. The experimenter informs them that they will be comparing the lengths of lines. He shows two large white cards. On one is a single vertical black line—the standard whose length is to be matched. On the other card are three vertical lines of various lengths. The subjects are to choose the one that is of the same length as the line on the other card. One of the three actually is of the same length; the other two are substantially different, the difference ranging from three quarters of an inch to an inch and three quarters.
>
> The experiment opens uneventfully. The subjects announce their answers in the order in which they have been seated in the room, and on the first round every person chooses the same matching line. Then a second set

Id. (footnotes omitted; emphasis in original).

71. *Id.* at 1140 ("Long hours, deadlines, and workplace politics can combine to take a toll on lawyers, as can lack of sleep, frequent interruptions, travel, difficult decisions, and the struggle to balance work and family life.") (footnote omitted).

> of cards is exposed; again the group is unanimous. The members appear ready to endure politely another boring experiment. On the third trial there is an unexpected disturbance. One person near the end of the group disagrees with all the others in his selection of the matching line. He looks surprised, indeed incredulous, about the disagreement. On the following trial he disagrees again, while the others remain unanimous in their choice. The dissenter becomes more and more worried and hesitant as the disagreement continues in succeeding trials; he may pause before announcing his answer and speak in a low voice, or he may smile in an embarrassed way.
>
> What the dissenter does not know is that all the other members of the group were instructed by the experimenter beforehand to give incorrect answers in unanimity at certain points. The single individual who is not a party to this prearrangement is the focal subject of our experiment. He is placed in a position in which, while he is actually giving the correct answers, he finds himself unexpectedly in a minority of one, opposed by a unanimous and arbitrary majority with respect to a clear and simple fact. Upon him we have brought to bear two opposed forces: the evidence of his senses and the unanimous opinion of a group of his peers. Also, he must declare his judgments in public, before a majority which has also stated its position publicly.
>
> The instructed majority occasionally reports correctly in order to reduce the possibility that the naive subject will suspect collusion against him. (In only a few cases did the subject actually show suspicion; when this happened, the experiment was stopped and the results were not counted.) There are 18 trials in each series and on 12 of these the majority responds erroneously.[72]

So what did Asch find? "Of the 123 put to the test, a considerable percentage yielded to the majority. Whereas in ordinary circumstances individuals matching the lines will make mistakes less than [one percent] of the time, under group pressure the minority subjects swung to acceptance of the misleading majority's wrong judgments in 36.8 [percent] of the selections."[73] That's a pretty big difference. Those who defied the group's "perception" tended to do so because of their confidence in their own judgment or out of a personal need to, in essence, call 'em as they saw 'em.[74] Those who bent to the group's "perception," though, did so even though they suspected that some of their colleagues (the actors who were creating the "majority" perception) were just playing along, or they did so

72. Solomon E. Asch, *Opinions and Social Pressure*, 193 SCI. AM. 31, 32 (1955).
73. *Id.* at 32–33.
74. *Id.* at 33.

because they thought that the majority was dealing with some sort of optical illusion (and didn't want to rock the boat); still others actually believed that they themselves were having perception problems.[75] As Asch observed, "All the yielding subjects underestimated the frequency with which they conformed."[76] So Asch varied his experiment. The size of the group of actors mattered—most dramatically when the number of actors increased from one to two and from two to three. After that, the number of actors contradicting the subject's own perception mattered much less.[77] Another important variation was the inclusion of a second person who could validate the experimental subject's own perceptions:

> Disturbance of the majority's unanimity had a striking effect. In this experiment the subject was given the support of a truthful partner—either another individual who did not know of the prearranged agreement among the rest of the group, or a person who was instructed to give correct answers throughout.
>
> The presence of a supporting partner depleted the majority of much of its power. Its pressure on the dissenting individual was reduced to one fourth: that is, subjects answered incorrectly only one fourth as often as under the pressure of a unanimous majority . . . . The weakest persons did not yield as readily. Most interesting were the reactions to the partner. Generally the feeling toward him was one of warmth and closeness; he was credited with inspiring confidence. However, the subjects repudiated the suggestion that the partner decided them to be independent.[78]

Let's put this phenomenon in the context of a law firm. A junior associate sits in on a meeting with a mid-level associate, a senior associate, and a partner. They talk about six different matters for a total of thirty minutes. Firm policy, at least in this hypothetical, is that the minimum billable increment is .25.[79] (Yes, I know that most firms bill in tenths of

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* at 34; *see also* ORI BRAFMAN & ROM BRAFMAN, SWAY: THE IRRESISTIBLE PULL OF IRRATIONAL BEHAVIOR 154–55 (2008) (discussing Asch's experiments).

79. Not only do most law firms bill in tenths of hours, but also more than a few firms have agreed internally not to bill their clients for conversations among the lawyers working on a matter. As my friend Scott Unger explains,

> I do not bill for sitting around speaking with others in my group. Clients would flip out. I tell younger associates I supervise not to do it. Of course, when working in teams on a file, we need

hours now. Humor me.) The partner says, "OK, that's .25 for each of six matters. Not bad: 1.5 hours for thirty minutes' worth of work." The senior associate nods, as does the mid-level associate. The junior associate now has to face the ethical dilemma: does she likewise record 1.5 hours of billable time, or—for those matters that only took a few minutes—does she decide only to bill .25 to those matters for which the discussion took at least ten minutes? My guess is that, unless one of the other associates speaks up, the junior associate is not only going to record 1.5 hours of time, but she's also going to justify her choice by thinking, "firm policy says that I need to put down at least .25 every time I work on something."[80] Maybe some of the lawyers in the firm use an unwritten

> to discuss the case and issues related to representation. We bill that time we spend talking amongst ourselves when we execute the action plan (researching, writing) or I bill it as a "no charge." I use the "no charge" code all of the time. That way, the client sees that I am not billing them for the discussions but am engaging in those discussions. I use the "no charge" code all of the time when I feel I am not adding value to a file. Billing it as "no charge" is a good way of keeping a client happy. Everyone likes something for free.

E-mail from Scott Unger to author (Sept. 21, 2013, 06:11 PM) (on file with author); *see also* J. Scott Bovitz, *Being a Great Lawyer (as a Partner)*, *in* NANCY B. RAPOPORT & JEFFREY D. VAN NIEL, LAW FIRM JOB SURVIVAL MANUAL: FROM FIRST INTERVIEW TO PARTNERSHIP 176–77 (2014) (encouraging the "no charge" notation on bills).

80. As Jennifer Robbennolt and Jean Sternlight have observed:

> Given all that we know about ethical blindspots, it would not be at all surprising if subordinate lawyers had difficulty making objective judgments about whether a question is "arguable" and about the "reasonableness" of the superior's resolution. And, as we have discussed, lawyers are skilled at making arguments on multiple sides of an issue. Thus, when a partner tells an associate to do something the associate initially finds ethically questionable, the associate may well be able to craft an argument to convince himself that the particular behavior is acceptable.
>
> Even in the absence of directions from an authority, ethical behavior can be influenced by other people. We learn how to comport ourselves, in part, by watching the actions of those around us, looking to see how others—particularly those with more experience or expertise—behave. "[L]awyers are social beings; like other human beings in social and occupational groups lawyers behave largely in accordance with group norms." For attorneys this might be other lawyers within a firm or agency, lawyers who share space, or other formal or informal advice networks—their "communities of practice." The more widespread an attorney believes a particular practice is, the more likely he is to indicate that he would engage in it and the more tempting the unethical behavior, the more widespread he will believe it to be.
>
> When [lawyers] begin work at law firms, they watch the more experienced lawyers to see what the real standards of conduct are. Each firm quickly communicates its institutional norms to new associates; many associates are anxious to assimilate themselves into an institution and to be successful within it. Therefore, they are not critical of the norms they are asked to adopt. They redraw their lines to fit into the value systems of their firms. If the senior lawyers are not precise in their billing practices, the junior lawyers will not be. If the senior lawyers exaggerate their credentials or expertise when talking with new clients, the

rule that certain very small increments stay "unbilled," or they wait until the number of very small increments add up to around .25, but if the junior associate doesn't get some clarification, she's just taught herself something that will eventually greatly annoy her clients.[81]

Or take another example of social pressure that Dustin Benham suggested to me:

> Imagine being a first-year lawyer and your task is to Bluebook a brief in a multi-million dollar appeal. You receive the brief last, after everyone's edits are in. You see a glaring legal problem but at least [five] other lawyers, including some who have argued at the highest levels of the profession, have written and/or studied the brief. The deadline is the next day and fixing the problem will trigger a request for an extension. I'd like to see the statistic on how many associates have the guts to sound the alarm. If it was [one] out of [ten], I'd be pleasantly surprised.[82]

Social pressure and diffusion of responsibility seem to be two cognitive errors that are most likely to apply to law firm life.[83] In Lisa Lerman's *Scenes from a Law Firm*,[84] Lerman provides excerpts from an interview with an associate who chose to remain anonymous.[85] That associate worked for a law firm from fall 1993 through all of 1994. His stories reflect significant social pressure effects. Here's an example:

> Sometimes I'd be reviewing a pre-bill and I'd look under "costs" and I'd see "150 copies." I didn't make 150 copies . . . . Someone had used the code for that particular case . . . . Every once in a while you'd pick up a file and the file was paper thin. There hadn't been any activity on it for a year, and yet there are 150 photocopies charged to that file . . . . I'd go back to the partner and say, "Look[,] somebody's been using the wrong code." And he would say, "Well, there's nothing we can do about that." I'd say, "Are we

junior lawyers will do the same.

Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1146-47 (2013) (quoting Lisa G. Lerman, *Lying to Clients*, 138 U. PA. L. REV. 659, 681 (1990)) (footnotes omitted).

81. States require that fees be reasonable. *See, e.g.*, MODEL RULE OF PROFESSIONAL CONDUCT 1.5(a) (2013) (charging .1 for a thirty-second conversation would trigger a consideration of this ethics rule).

82. E-mail from Dustin Benham to author (Oct. 10, 2013, 01:31 PM) (on file with author).

83. Hat tip to my buddy Bernie Burk.

84. Lisa G. Lerman, *Scenes from a Law Firm*, 50 RUTGERS L. REV. 2153 (1998).

85. *Id.* at 2153–54.

> going to charge it to that client?" He goes, "Well[,] it's the same client . . . . It's the insurance company that pays the bill, so whether it is on that file or another . . . . What difference does it make?" It's a big faceless, giant insurance company. What's 150 copies at twenty cents a page?[86] Well, it's exactly that amount.[87]

That associate knew that billing 150 pages to the wrong matter was not ethical, and yet that's what the firm wanted him to do, just as the firm wanted him to change some paralegal and secretarial time to indicate that an attorney had done the work.[88] It takes a strong personality to overcome that much social pressure, and Lerman's anonymous lawyer isn't alone in experiencing pressure to behave unethically.[89] Couple social pressure with diffusion of responsibility, and you get a big mess. If everyone at a law firm believes that someone else at the firm is the firm's "moral conscience," then only the person with the title of "ethics guru"[90] (or those who serve on the firm's ethics committee) will get tagged with the responsibility of making sure that everyone in the firm conforms to the ethics rules. In a sense, diffusion of responsibility outsources ethical responsibility from "everyone" to "the guru." Clearly, then, if we decide that we want to change some behaviors inside a law firm,[91] we need to take social pressure and other cognitive errors into account.[92]

86. Cognitive dissonance would lead the billing partner to say to himself, "Yes, we billed the copies to the wrong client, but fixing the problem would cost more than the original $30 mistake, so it's not cost-effective to fix the problem." (Maybe not, but writing off the $30 *would* be cost-effective.).

87. Lisa G. Lerman, *Scenes from a Law Firm*, 50 RUTGERS L. REV. 2153, 2161–62 (1998) (punctuation in original).

88. *Id.* at 2162.

89. *See, e.g.*, Lawrence K. Hellman, *The Effects of Law Office Work on the Formation of Law Students' Professional Values: Observation, Explanation, Optimization*, 4 GEO. J. LEGAL ETHICS 537, 601–08 (1991) (discussing the disconnect in ethical behavior that his students observed).

90. The "ethics guru" model works best when the guru is a powerful lawyer within the firm, and it works significantly less well when the guru has little gravitas.

91. When you add some of the other cognitive errors that we make to the phenomenon of social pressure, you get statistics like this: "In a 2009 study of 2,800 employees, 49 percent reported they had observed some type of wrongdoing on the job in the previous year, despite the considerable efforts that organizations are taking to improve their employees' ethical behavior." MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 81 (2011).

92. As Ori and Rom Brafman have noted:

> A growing body of research reveals that our behavior and decision making are influenced by an array of [unseen] psychological undercurrents and that they are much more powerful and pervasive than most of us realize.

III. CHANGING BEHAVIOR BY CHANGING INCENTIVES AND DEFAULT RULES

An organization's culture is built over time as members develop beliefs, values, practices, and artifacts that seem to work and are transmitted to new recruits. Defined as "the way we do things around here," culture anchors an organization's identity and sense of itself.[93]

A. *The Importance of Setting the Correct Cultural Expectations As a First Step.*

Before a law firm can find ways of fine-tuning people's behavior, it has to figure out the culture that it wants to inculcate. We could spend hours reading all of the literature suggesting that lawyers have moved away from being professionals to being businesspeople, but the fact remains that law firms are both; they are businesses that need to make a profit, and they are organizations of professionals who need to remember their duties to their clients and to the system as a whole. How the people in a firm behave when they face ethics issues will, over time, shape the cumulative level of firmwide ethics. Again, it's not what the firm says on its webpage, in its Human Resources manuals, or in meetings that counts; it's how people in authority signal, consciously or subconsciously, how they want their colleagues to act.

Even the tired old phrases such as "scorched-earth litigators" or "hard-nosed negotiators" will signal to the rank-and-file that they should be exceptionally aggressive.[94] Firms that promote themselves as being more

> . . . These hidden currents and forces include loss aversion (our tendency to go to great lengths to avoid possible losses), value attribution (our inclination to imbue a person or thing with certain qualities based on initial perceived value), and the diagnosis bias (our blindness to all evidence that contradicts our initial assessment of a person or situation).

ORI BRAFMAN & ROM BRAFMAN, SWAY: THE IRRESISTIBLE PULL OF IRRATIONAL BEHAVIOR 16–17 (2008).

93. LEE G. BOLMAN & TERRENCE E. DEAL, REFRAMING ORGANIZATIONS: ARTISTRY, CHOICE, AND LEADERSHIP 277–278 (4th ed. 2008).

94. Go back to Lisa Lerman's anonymous associate:

> From the very beginning . . . I was told that "[w]e are not out to churn out five Cadillacs or Mercedes-Benz[e]s a year, what we are here to churn out is 150 Fords." "We'd rather that you would do a C job on 150 cases than an A job on fifty cases." "You have to 'add value' to the

collaborative, on the other hand, are signaling that they want less aggressive behavior. So, for example, if you place two law firms side by side, and Firm A specializes in take-no-prisoners divorce but Firm B specializes in collaborative divorce, you'd expect very different behavior from the professionals in those firms.[95]

Firms that want to develop a specific culture have to pay attention both to the behavior of those already in the firm[96] and the likely behavior of those who are invited to work there.[97] The recent *Harvard Business Review* case study of the Duane Morris firm provides a useful example. In considering lateral partners, the firm looks for "specific personality traits in

---

> firm." That comment came in repeatedly . . . . "We're paying you X amount of dollars and it's costing us this much to keep you on board, so you have to find a way to make yourself profitable." Much of this instruction came from associates with seniority; they were trying to tell me how to survive at the firm. The partners never said these things to me, but it was clear that the partners rewarded those who worked by this philosophy.
>
> That usually meant handling a large number of cases and doing a B grade job. It had nothing to do with doing quality legal work, or client maintenance, or establishing long-term relationships with clients. "Adding value" meant churning out as many billable hours as you could and doing as much marketing as you could.

Lisa G. Lerman, *Scenes from a Law Firm*, 50 RUTGERS L. REV. 2153, 2156 (1998).

95. Here's an example from a *Harvard Business Review* case study about Duane Morris: One partner mentioned:

> We as a firm have always had a "no jerks" rule. That is something that I personally take very seriously. I would say to anyone asking about Duane Morris that if someone is going to behave poorly, they had better do it quietly, because we do not tolerate rude or unprofessional conduct around the office. If anyone yelled at a staff member, oh my, I mean that lawyer would be ostracized quickly and hopefully would change their ways immediately. We are very protective of our culture.

[Chief Operating Officer] O'Donnell added:

> You don't need to be a screamer to get things done here. Because the staff feels valued they continue to perform at a very high level—we don't have any laggards. People are often recognized by partners and clients for the jobs they do. I'll get at least one email a week congratulating somebody, thanking somebody or a group of people—and they will mention the secretaries, the marketing people and others involved. So we have a lot of people looking to give credit, rather than take credit. That is a virtuous circle.

Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 8 (July 26, 2013).

96. My buddy George Connelly has correctly pointed out to me the changes that I'm proposing in this article can affect up to four generations of professionals at a time. That's a lot of change for a great many people, and I'm cognizant that trying to make all of these changes at once, without much discussion at a firm beforehand, is a recipe for disaster.

97. For a discussion of what I think is the wrongheaded way that many firms hire new associates, see *infra* notes 184–86 and accompanying text.

new hires, alongside the requisite professional skills. The ideal candidate [is] collegial, task-oriented and a team player."[98] Those potential partners receive detailed financial information about the firm and must fill out "a Lateral Partner Questionnaire (LPQ) that include[s] information about their clients, the portability of those clients, the partner's billing reports, and a personal business plan."[99] There's a lot of due diligence that occurs on both sides of a potential lateral move at Duane Morris. Once hired, the new laterals get specific mentoring and training to make sure that there's a good culture match.[100] The philosophy at the firm seems to follow that old adage, "act in haste and repent at leisure." The extra investment before and immediately after hiring is an effort to build a specific culture at a conscious level.

Whether we're talking about law firms, Fortune 100 businesses, or fast-food franchises, the countless subtle signals that occur each day will socialize people to behave one way or another.[101] Add to the mix what we know about cognitive errors, and you can see how important it is for law firms to be aware of just what type of behavior they're eliciting. As Jennifer Robbennolt and Jean Sternlight have pointed out, "The stories that get told around the office send messages about what is valued. These messages can either reinforce or undermine the more formal ethics polices

98. Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 12 (July 26, 2013). The firm also looks for the trait of collegiality in those people applying for associate positions. *Id.* Maybe every firm believes that it does a good job of screening for collegiality when considering laterals. The trick—just as much here as with any other company policy—is to see if the words match the actions.

99. *Id.* I'll bet that Dewey's former partners now wish that they'd done something along these lines when they brought in their expensive laterals.

100. *Id.* at 13.

101. The "we include support staff in our congratulatory emails" signal is important for setting the tone. *Id.* Other companies have their own distinctive tones and signals:

> Like Enron, Johnson & Johnson has well-established codes of conduct. Why, then, have we witnessed such dramatic differences between these two companies in terms of ethical behavior? Differences in the length and content of the [codes of conduct] are probably not to blame. More likely, the real difference can be traced to the informal cultures in which these formal systems were embedded. Johnson & Johnson is widely known for its ethical culture . . . . [I]ts formal code of ethics was consistent with its informal culture . . . . By contrast, Enron became notorious for its underlying culture of greed and competition.

MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 118 (2011).

of the organization."[102] Moreover, if a law firm never discusses its professionals' behavior in a large setting (say, an all-hands departmental meeting), then its professionals will keep making ethics decisions in a vacuum.[103] Firms need to be deliberate and clear in their discussions about ethics.[104] More important, they need to think long and hard about how to structure their professionals' work environments to encourage good choices.

B. *Considering Entitlements: Perceived Losses Versus Perceived Gains*

If a firm wants to change its people's behavior, the first thing that its management should realize is that changing behavior in an existing organization—rather than starting fresh with a new organization—is likely to create frustration and anxiety for those who have to alter their old

102. Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1168 (2013) (footnotes omitted); *see also* MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 123–24 (2011) ("Informal norms don't even require a complete story to become ingrained in an organization or society. The words we choose to describe, or disguise, behaviors can be just as effective. . . . [E]uphemisms send a powerful informal signal about an organization's values to its employees: as long as you disguise and hide your unethical behavior, we will accept it, and indeed even encourage it.").

103. Scott Killingsworth, *Modeling the Message: Communicating Compliance Through Organizational Values and Culture*, 25 GEO. J. LEGAL ETHICS 961, 984 (2012) ("[I]n most cases, the outcomes of disciplinary actions are kept confidential, mainly for fear of privacy or defamation claims by disciplined employees. This invisible discipline can lead others to assume that the company is not following up on misconduct, which in turn could suppress reporting.").

104. As discussed by Jennifer Robbennolt and Jean Sternlight in *Behavioral Legal Ethics*:

> The challenges of learning from ethical mistakes affect legal organizations as well as individual lawyers. One study of how ethics were handled in law firms found that "information regarding the nature of the problems or questions, and how they are resolved was rarely, if ever, fed back into the firm. Both associates and partners seemed unaware of the extent of reported (or unreported) problems, questions, or violations of ethical standards." Yet, when there is no feedback, learning will suffer, and this may lead to further deterioration in the entity's ethical norms.
>
> The mindset with which one approaches mistakes can make a tremendous difference in one's ability to learn from them. Specifically, those with a *fixed mindset* see mistakes as an indication of incompetence or stupidity, react to them with anger or depression, and therefore miss out on opportunities to learn and improve. But those with a *growth mindset* see mistakes as opportunities to learn how to do better. Thus, part of establishing an ethical culture is to inculcate a learning or growth orientation to dealing with mistakes—providing and embracing opportunities for self-criticism.

Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1173 (2013) (footnotes omitted; emphasis in original).

habits.[105] If people perceive themselves as giving up something that they've "always" had (a way of entering billable time, say), they're going to be feeling the effect of a perceived loss.[106] As economists will tell you, people hate dealing with a perceived loss a lot more than they like getting a perceived gain:

> Behavioral decision research has demonstrated that, on average, choices are not reference point independent, as rational choice theory assumes. For most people, perceived losses weigh more heavily than equivalent gains. A consequence of this is known as the "status quo bias": people prefer the status quo state of the world to change, all other things equal. A more specific version of the status quo bias is the "endowment effect": many people seem to value a tangible item or a legal right if they possess it than if they do not, especially when the item does not have a close market substitute.

105. Change doesn't always create negative emotions, of course; some change is positive and very much welcomed. But much depends on who's initiating the change. Change foisted upon someone is often stressful; change initiated by the person who wants to change might not be.

106. For example, partners who have worked at law firms at which compensation was lockstep would likely feel a sense of loss if that lockstep arrangement was changed to a compensation rubric that depended in part on someone's individual performance. *See, e.g.*, ELLEN JOAN POLLOCK, TURKS AND BRAHMINS: UPHEAVAL AT MILBANK, TWEED 201 (1990) (describing the perceived effect of moving away from lockstep compensation).

Here's another recent example: Faculty members at Penn State protested the university's decision to dock them $100 a month if they didn't provide the university's chosen health insurance provider with certain information about themselves. Although the university could have used a knowledge of perceived gains versus perceived losses to encourage faculty members to provide this information, it decided to be more straightforward:

> Penn State . . . did consider alternate ways of introducing a cost-containment strategy—like artificially inflating employees' premiums by 35 percent and then offering a discount to those willing to participate in the wellness program. But administrators felt that the $100 surcharge was more transparent. "It was an intentional design to drive participation . . . and it is driving participation."

Natasha Singer, *On Campus, a Faculty Uprising Over Personal Data*, N.Y. TIMES, Sept. 15, 2013, *available at* http://www.nytimes.com/2013/09/15/business/on-campus-a-faculty-uprising-over-personal-data.html?pagewanted=all&_r=0. In a way, I applaud Penn State's desire to be transparent; on the other hand, the faculty's reaction to Penn State's transparency gave me that "so how's *that* working out for you?" feeling, especially because UNLV took the other tack with us. We had the opportunity to cut our monthly premiums by providing certain information to the insurance company. Apparently, that "perceived losses vs. perceived benefits" theory works pretty well—well enough, in fact, that Penn State reversed its decision and eliminated the penalty soon after the issue made the national news. *See id.* (stating that Penn State University abolished its faculty health plan penalties after much negative publicity).

> Assume now that an individual would prefer A to B if she possessed neither. Given current background entitlements, however, she has an ownership interest in B, but not in A. She is given the opportunity to exchange B for A but, as a consequence of loss aversion, she rejects the offer. Is this choice welfare maximizing, or not? The answer depends on whether we believe that heuristic-influenced preferences are more reflective of "true" utility than heuristic-influenced judgments are reflective of true facts or probabilities.[107]

Consider the feeling of perceived loss that Yahoo employees must have felt when Marissa Mayer banned flextime.[108] For those who may not be old enough to remember, "office work" usually entailed being physically present in an office—and dressing up for work—for at least forty hours a week, each week, except for sick days, holidays, and vacation days. Office work did not mean "telecommuting," or "working while drinking coffee in a coffee shop that has WiFi," or "working four ten-hour shifts and getting one weekday off a week." It meant working 8-5, or 9-6, daily, with actual face time. Flextime was designed to meet the needs of those employees whom a company wanted to retain and whose jobs really didn't require them to be physically present in the office for forty solid hours a week. If Yahoo employees had never had the option of flextime, then losing it

107. Russell Korobkin, *What Comes After Victory For Behavioral Law and Economics?*, SSRN, 10–11 (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787070 (footnotes omitted); *see also* ORI BRAFMAN & ROM BRAFMAN, SWAY: THE IRRESISTIBLE PULL OF IRRATIONAL BEHAVIOR 19 (2008) ("For no apparent logical reason, we overreact to perceived losses."); RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 57 (2009) ("Roughly speaking, losing something makes you twice as miserable as gaining the same thing makes you happy . . . . What this means is that people do not assign specific values to objects. When they have to give something up, they are hurt more than they are pleased if they acquire the very same thing."); Nathan Novemsky & Daniel Kahneman, *The Boundaries of Loss Aversion*, XLII J. MARKETING RESEARCH 119 (May 2005) (proposing psychological principles to describe the limits of loss aversion). To make things more complicated, from a "rational actor" perspective, every human isn't the "same" sort of "rational": "As a by-product of challenging the traditional, heroic assumptions of law and economics about the extent of human cognitive ability, research in behavioral decisionmaking also implicitly undermines the assumption of identical cognitive ability across individuals. This consequence of the behavioral revolution is sometimes overlooked by legal scholars, who often assume deviations from behavior predicted by rational choice theory will be similar across individuals." Russell Korobkin, *What Comes After Victory For Behavioral Law and Economics?*, SSRN, 14 (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787070 (footnotes omitted).

108. *See, e.g.*, Jenna Goudreau, *Back to the Stone Age? New Yahoo CEO Marissa Mayer Bans Working From Home*, FORBES (Feb. 25, 2013), *available at* http://www.forbes.com/sites/jennagoudreau/2013/02/25/back-to-the-stone-age-new-yahoo-ceo-marissa-mayer-bans-working-from-home/ (debating the effect of Mayer's decision to resolve flextime privileges).

wouldn't have been an issue. But they did have it, and they lost it, and many of them were mighty unhappy about that loss. Giving employees flextime where they hadn't had it before is a "perceived gain"; taking it away after it's been a company policy is a "perceived loss." Guess which one engendered stronger emotions?[109]

Let's assume, then, that we're members of the management team of a hypothetical law firm that is utterly committed to using default rules and incentives to become a better place, both in terms of ethics and in terms of profitability. We know that we're going to have to change how some of our people behave—and what we're going to let them do—if we want to improve our firm. We know, too, that just changing policies on paper will be useless. In pop-culture-speak, we're going to have to "talk the talk and walk the walk." Let's also make a mental note that, when we start trying to change some behavior within the firm, we're going to have to take into account the extra resistance that we'll face in creating perceived losses.[110]

C. *Default Rules and Incentives*

> *It's not just that defaults matter; it's that they matter far more than most of us expect them to matter.*[111]

One of the first things that the hypothetical management team will have to identify is just what behavior it wants to change. Maybe it wants to encourage billers to submit their time contemporaneously, or nearly so, with the work that they do, so that the entries for billable time are more accurate. Maybe it wants billers to do a better job of describing what they've done in their time entries. Maybe it wants partners to staff matters more efficiently. Maybe it wants to encourage partners in different practice areas or across all of the firm's offices to cross-sell in order to keep more client matters within the firm, rather than losing out to other law

109. The same principle applied to those law firms that tried "business casual Fridays" or allowed "business casual" clothing every day. Most law firms used to be fairly stuffy places with written or unwritten dress codes. Having the opportunity to dress down, even if "dressing down" meant wearing khakis and a polo shirt, was a perceived gain. Going back to more formal clothing was a perceived loss.

110. To the extent that we might be able to characterize the change (ethically) as a perceived gain, that change might be easier for people to accept.

111. MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 167 (2011).

firms. Maybe it wants to encourage senior lawyers to spend more time mentoring junior lawyers.[112]

The management team could try exhortation. It could host lunches at which it describes, in rosy terms, all of the behavior that it wants to encourage. It could even try putting brightly colored posters in the kitchens.[113] But creating or changing some default rules and tweaking some incentives might yield better results. Just as Bank of America has gotten people used to putting their ATM cards back in their wallets[114] before entering their passwords and to moving fractions of a dollar to their savings accounts each time that they use their debit cards, law firms could think creatively about ways in which minor changes in "how things are done" could reap some benefits.

Let's consider an example of how a non-law-firm environment uses minor changes to encourage different behavior. We know that grocery stores place certain goods in certain places in order to encourage consumption. As David Brooks pointed out in his piece on *The Nudge Debate*:

> It's hard to feel that a cafeteria is insulting my liberty if it puts the healthy fruit in a prominent place and the unhealthy junk food in some faraway corner. It's hard to feel manipulated if I sign up for a program in which I can make commitments today that automatically increase my charitable giving next year. The concrete benefits of these programs, which are empirically verifiable, should trump abstract theoretical objections.[115]

I suppose that, if Brooks was used to having unhealthy food placed at eye level in the cafeteria and had to hunt for it in a more inconvenient location, he might feel a perceived loss when the healthy food was moved to eye level. The relocation of healthy food, then, would have to provide twice as much of a perceived gain in order to cancel out the perceived loss of having to hunt harder for the unhealthy food.[116]

112. While, of course, still billing enough time to help the firm's bottom line.

113. Walter Effross came up with an even better idea: "[O]r, since stores that want to prevent shoplifting have had success putting in life-sized cardboard models of police officers, maybe use mockups of managing partners." Email and attachment from Walter Effross to author (Sept. 20, 2013) (on file with author).

114. Or between their teeth.

115. David Brooks, *The Nudge Debate*, N.Y. TIMES, Aug. 8, 2013, http://www.nytimes.com/2013/08/09/opinion/brooks-the-nudge-debate.html?_r=0.

116. *But see* David A. Friedman, *Micropaternalism*, Draft, *available at* http://ssrn.com/abstract=2236446 (examining the concept of micropaternalism and what must be done in order to overcome perceived losses); Michelle Castillo, *Million Big Gulp March to Protest Proposed NYC Soda*

Let's go back to the law firm environment. Some firms clearly have tried various types of incentives and default rules. At least one firm has created a contest (*e.g.*, "Mentor of the Year") to encourage senior lawyers to mentor junior ones. The names of the top three mentors each year are circulated to the whole firm, and I've heard that the mentors who place second and third are often motivated to go around to the junior lawyers and ask, "what more could I do to place first?"[117] And the law firm of Gray Plant Mooty has its Mooty Award, which recognizes (across all job titles, including receptionists) business development, marketing, and client service activities.[118] Law firms really are trying to come up with ways to encourage different behavior, with varying amounts of success.

If we want to, as the hypothetical management team, make it more difficult for lawyers to do things that we don't like (such as turning in their timesheets late) or make it easier for lawyers to do what we want (such as

Ban, CBS NEWS (July 9, 2012, 4:40 PM) http://www.cbsnews.com/8301-201_162-57468681/million-big-gulp-march-to-protest-proposed-nyc-soda-ban/ (defining the situation as a protest against the government "dictating how people should live"); Verena Dobnik, *New York Soda Ban: Rally Held Against Bloomberg's Proposal*, HUFFINGTON POST (July 9, 2012, 10:15 PM) http://www.huffingtonpost.com/2012/07/10/new-york-soda-ban-rally-bloomberg_n_1661423.html ("[A] small, peaceful protest rally against a ban on big sodas on a sidewalk near City Hall Park – dubbed The Million Big Gulp March."); Chris Dolmetsch & Henry Goldman, *New York Soda Size Limit Statute Barred by State Judge*, BLOOMBERG.COM (Mar. 11, 2013, 3:30 PM) http://www.bloomberg.com/news/2013-03-11/new-york-city-soda-size-limitations-barred-by-state-court-judge.html (discussing a New York state judge's attempt to block Mayor Michael Bloomberg's ordinance "limit[ing] the size of sugary soft drinks sold in restaurants, movie theaters, stadiums and arenas to no more than 16 ounces (473 milliliters) a cup").

117. Conversation with Marty Brimmage and Lacy Lawrence at Texas Bench-Bar Conference (June 2013). Of course, depending on the proportionality of such an award to some of the other behaviors being rewarded at a firm, a mentoring award could backfire, much in the same way that teaching awards at universities sometimes backfire by causing the non-winners to think that the winner is not "serious" about scholarship.

118. *See Value: How You Define It, Year in Review 2012*, GRAY PLANT MOOTY http://www.gpmlaw.com/_includes/2012-GPM-YearInReview.pdf 26 (last visited Jan. 24, 2014)

> John Mooty once said, 'Nothing is more important to the longevity of the firm than business development. It is the responsibility of everyone.' The aptly named Mooty Awards were established in 2005 as a way to publicly recognize Gray Plant Mooty employees who have excelled in the areas of business development, client service, and marketing during the year. Past recipients have ranged from LAAs, paralegals, and associates to principals and administrative staff."

Id. That the firm recognizes the importance of every employee to client service is especially significant.

phrasing descriptions in bills in a certain way), we could develop a system of default rules. There are two kinds: opt-in and opt-out. An example of an opt-in rule is Nevada's system for noting a person's organ donor status on a Nevada driver's license: check a box, and your license includes the notice that you want to donate some or all of your organs.[119] You have to do something extra—by checking a box—to opt in.[120] Checking a box isn't onerous, but it is an additional step. If Nevada wanted to make it easier for people to become organ donors, it could create an opt-out system in which everyone with a driver's license is a donor unless he or she checks a box to remove that designation. The more strongly we believe that we want to encourage a particular behavior, the more likely it is that we'd create an opt-out rule to make that "good" behavior dominant.[121] For example, if we want to encourage billers to describe certain activities in detail, then we might want to make it easier to enter detailed descriptions[122] than to enter vague descriptions like "attention to matter."[123] Incentives and default rules could help us "nudge" behavior. But we also have another tool to use: checklists.

119. *Organ Donation*, ST. OF NEV. DEPT. OF MOTOR VEHICLES http://www.dmvnv.com/dlorgan.htm (last visited Jan. 24, 2014).

120. *Id.* The decision to become an organ donor might be difficult, but the act of checking a box certainly isn't. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 178–82 (2009) (quoting ORGAN DONATION: OPPORTUNITIES FOR ACTION 217 (James F. Childress & Catharyn T. Liverman eds., 2006)) (discussing the concept of opt-in organ donation); *see also* MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT 17, 167 (2011) (detailing the stark difference between opt-in and opt-out organ donation policies); NUDGE BLOG, *Richard Thaler on Organ Donation* (Sept. 27, 2009) http://nudges.org/2009/09/27/richard-thaler-on-organ-donation/ ("Here is how it works: When you go to renew your driver's license and update your photograph, you are required to answer this question: 'Do you wish to be an organ donor?'").

121. *See, e.g.*, JENNIFER K. ROBBENNOLT & JEAN R. STERNLIGHT, PSYCHOLOGY FOR LAWYERS: UNDERSTANDING THE HUMAN FACTORS IN NEGOTIATION, LITIGATION, AND DECISION MAKING 88–97 (2012) (describing the varying psychological influences that affect people's choices and behaviors).

122. Even after all these years, I still use the abbreviations that my firm taught me for recording meetings ("MW") and calls ("TW").

123. Creating certain ways of recording our tasks just requires us to be creative. We could, for example, come up with some program that refuses to let us input vague language. I'll discuss billing and computer programs in more detail below. And as I'll say again below, no fair stealing my ideas here. If there's going to be an app that prevents attorneys from entering descriptions that are too vague, I want a piece of the action.

D. *Norming Behavior Through Checklists*[124]

> *An investigation [into the crash of a Boeing 299 prototype plane] revealed that nothing mechanical had gone wrong. The crash had been due to "pilot error," the report said . . . .*
>
> *Still, the army purchased a few aircraft from Boeing as test planes, and some insiders remained convinced that the aircraft was flyable. So a group of test pilots got together and considered what to do.*
>
> *What they decided not to do was almost as interesting as what they actually did. They did not require Model 299 pilots to undergo longer training . . . . Instead, they came up with an ingeniously simple approach: they created a pilot's checklist. . . .*
>
> *. . . You wouldn't think it would make that much difference. But with the checklist in hand, the pilots went on to fly the Model 299 a total of 1.8 million miles without one accident. The army ultimately ordered almost thirteen thousand of the aircraft, which it dubbed the B-17.*[125]

---

124. Thinking about checklists got me thinking about "fast" and "slow" types of thinking. Daniel Kahneman and others use the shorthand of "System 1" and "System 2" thinking to describe the "fast" and "slow" thinking in which humans engage:

> Behavioral decision theorists, including Daniel Kahneman in his Nobel laureate address, have suggested that human beings have two mental strategies for responding to the problems of the world, the first being intuition and the second reasoning. These divergent approaches are sometimes referred to as "System 1" and "System 2." System 1 is "fast and frugal." It is automatic, reliant on simplifying heuristics, and relatively undemanding of cognitive effort and capacity. It allows us to navigate our way through the morass of judgments and decisions that life calls upon us to make constantly. Without it, few of us could make it through the day. But while it is clearly adaptive overall, its speed and information frugality can cause errors in individual circumstances. System 2 is more deliberate, is analytical in nature, and is able to take into account more information. It resembles, in quality if not always in degree, the type of non-selective, fully compensatory analysis assumed to be universal by rational choice theorists. Rather than taking shortcuts to ensure speed, the System 2 reasoning process takes into account all information relevant to a particular decision. When used selectively, System 2 reasoning can improve the overall quality of judgments and decisions, but its cumbersome nature makes it an impractical basis for decision making except on relatively rare occasions.

Russell Korobkin, *What Comes After Victory For Behavioral Law and Economics?*, SSRN, 15–16 (2011), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1787070 (footnotes omitted); *see also* DANIEL KAHNEMAN, THINKING, FAST AND SLOW 20–21, 26 (2011) ("One of the tasks of System 2 is to overcome the impulses of System 1. In other words, System 2 is in charge of self-control.").

125. ATUL GAWANDE, THE CHECKLIST MANIFESTO: HOW TO GET THINGS RIGHT 33–34 (2009). One wonderful example of the use (and importance) of checklists is Felix Baumgartner's checklist for his 128,000-foot jump to Earth. *See [Official] Felix Baumgartner Freefall From the Edge of Space with New World Record*, YOUTUBE (Oct. 15, 2012), http://www.youtube.com/watch?v=VKojXTWJIhg (showing Felix Baumgartner's world record 128,000-foot freefall from

Let's say that one of our frustrations on the management team is that some of the lawyers in our firm are not particularly imaginative at clearing conflicts. They list the obvious potentially adverse parties, but they occasionally miss whole swaths of groups that they need to consider in certain types of conflicts checks. If our management team could reach an agreement on the categories that we'll always want our lawyers to check in certain types of cases, we could create (and mandate the use of) checklists to make sure that everyone is on the same page.[126] Chances are good that some lawyers would resent the very idea of a checklist,[127] but most probably would be willing to use checklists in order to avoid the ramifications of a bad conflicts check.

Not everything in a lawyer's day lends itself to a checklist, but some things do.[128] Conflict checks are one example;[129] making sure that a

space).

126. In a discussion with me, Dave McGowan came up with the very sensible suggestion of adding a splash screen to a firm's conflicts-checking process, either showing recent cases in which a failure to check conflicts cost a law firm a lot of money or showing a reminder about how often the firm had had to withdraw in the middle of a matter because of a missed conflict (e.g., "Last year, we spent $*x* dealing with conflicts.").

127. *See* ATUL GAWANDE, THE CHECKLIST MANIFESTO: HOW TO GET THINGS RIGHT 173 (2009) (discussing how a professional's pride can interfere with his willingness to use checklists).

> We don't like checklists. They can be painstaking. They're not much fun. But I don't think the issue here is mere laziness. There's something deeper, more visceral going on when people walk away not only from saving lives but from making money. It somehow feels beneath us to use a checklist, an embarrassment. It runs counter to deeply held beliefs about how the truly great among us—those we aspire to be—handle situations of high stakes and complexity. The truly great are daring. They improvise. They do not have protocols and checklists.
>
> Maybe our idea of heroism needs updating.

Id.

128. *See id.* at 48–49 (emphasizing that simple problems can often be fixed with checklists).

> Two professors who study the science of complexity—Brenda Zimmerman of York University and Sholom Glouberman of the University of Toronto—have proposed a distinction among three different kinds of problems in the world: the simple, the complicated, and the complex. Simple problems, they note, are ones like baking a cake from a mix. There is a recipe. Sometimes there are a few basic techniques to learn. But once these are mastered, following the recipe brings a high likelihood of success.
>
> Complicated problems are ones like sending a rocket to the moon. They can sometimes be broken down into a series of simple problems. But there is no straightforward recipe. Success frequently requires multiple people, often multiple teams, and specialized expertise. Unanticipated difficulties are frequent. Timing and coordination become serious concerns.
>
> Complex problems are ones like raising a child. Once you learn how to send a rocket to the moon, you can repeat the process with other rockets and perfect it. One rocket is like another rocket. But not so with raising a child, the professors point out. Every child is unique.

complaint alleges everything necessary to support a cause of action is another; and making sure that all cross-references in a transactional document have been proofread before the final version is executed is yet another. Law firms, of course, are already using checklists for some purposes. For example, Skadden[130] uses them to make sure that attorneys who come in as laterals get all of the information that they need to make a complete transition to their new firm.[131] So we might consider using checklists to develop staffing parameters when we're proposing to a client how we might staff a given matter. Of course, every checklist has to be accurate and credible, or no one will use them. Our checklists would have to be both concise and precise,[132] and they would have to be tested repeatedly to make sure that they work.[133]

Now, armed with the knowledge that humans are hard-wired to make certain cognitive errors, that we have a responsibility to ensure that our employees behave ethically, that taking things away from them will bother them more than giving them new things will make them happy, that some behaviors might lend themselves to default rules, incentives, or checklists, and that (unfortunately) the odds of us calibrating our changes correctly are very, very small, let's still give it a whirl. What things would we like to change in our hypothetical law firm, and how might we change them?

> . . . And this brings up another feature of complex problems: their outcomes remain highly uncertain. Yet we all know that it is possible to raise a child well. It's complex, that's all.

Id.

129. For example, a law firm could have separate checklists for different practice areas, so that a conflicts check for bankruptcy matters would review a firm's "connections," which is a term of art in bankruptcy cases. *See* FED. R. BANKR. P. 2014 (describing what types of disclosures are necessary).

130. SKADDEN, http://www.skadden.com/ (last visited Jan. 13, 2014).

131. I learned about Skadden's use of checklists in a conversation that I had with Jodie Garfinkel, who runs the firm's training program.

132. *See* ATUL GAWANDE, THE CHECKLIST MANIFESTO: HOW TO GET THINGS RIGHT 128 (2009) ("It is common to misconceive how checklists function in complex lines of work. They are not comprehensive how-to guides, whether for building a skyscraper or getting a plane out of trouble. They are quick and simple tools aimed to buttress the skills of expert professionals. And by remaining swift and usable and resolutely modest, they are saving thousands upon thousands upon thousands of lives.").

133. I don't consider checklists to be in the same category as either default rules or incentives, but I do believe that they're useful as a tool to make certain activities more consistent.

IV. SOME POSSIBLE DEFAULT RULES FOR BIG LAW FIRMS.

Here are some behaviors that come to mind: billing habits; staffing decisions; cross-selling across departments or locations; mentoring junior lawyers and staying involved with summer associates; *pro bono* work or other community involvement; networking; willingness to move from one practice group to another; willingness to raise ethics issues with superiors; and involvement with the many annoying surveys that law firms are asked to fill out. Whew—that's a lot of things that we might consider changing.

Before we choose some behaviors that we might want to change, let's start with one overall point. If we want people to change behavior, then we're going to have to empower everyone (not just the highest-ranking people) to be able to point out that the rules governing a particular behavior have changed (or should change). The overall structure of the firm must be one in which a first-year associate (or paralegal or not-so-powerful mid-level or senior lawyer) must be able to raise an ethics issue without fear of being marginalized or fired. It's not enough to say that everyone has a responsibility to make sure that the ethics rules are followed. We have to make the law firm a safe place to point out when someone has difficulty following the rules.[134] Ron Rotunda certainly made this point when he said:

> Granted, the ethics rules tell us that there is no defense to following bad orders. But the existence of that principle does not make it easy for the associate to challenge the partner or for the partner to challenge his major client and tell him that either he will turn over the document or the client can walk out the door. However, a law firm will make it easier for the associate or the partner to do the right thing if it creates a structure that overcomes these disincentives to be ethical. The firm should create incentive to encourage the younger lawyers to ask questions without feeling that they are being insubordinate.[135]

It helps a great deal when the actual structure of the law firm encourages people to raise ethics questions—say, with an inside lawyer or a committee

134. The wonderful Nettie Mann pointed out to me that, in the military, not following the rules—and especially not following orders—can lead to a dishonorable discharge, depending on the severity of the insubordination. *See* 10 U.S.C. § 892 (2012) (explaining that a failure of a Service Member to follow an order or regulation is an offense punishable by court-martial).

135. Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 702–03 (2011) (footnote omitted).

charged with being the "ethics guru."[136] Even when there's not an internal point-person or committee, though, the single largest predictor of whether people will come forward to raise ethics questions will be how the firm has treated those who raised such questions previously.[137] The lore of the firm might be that those who raised ethics questions were relegated to the legal equivalent of Siberia. Alternatively, the lore could be that (even if the law firm ultimately disagreed that there was an ethics problem) the person raising the question ended up feeling as though he or she had done the right thing by bringing it to the firm's attention.[138] A firm

136. *See* Elizabeth Chambliss & David B. Wilkins, *A New Framework for Law Firm Discipline*, 16 GEO. J. LEGAL ETHICS 335, 346 (2003) (proposing that law firms have a mandatory internal specialist to oversee firm compliance with ethics rules). On the other hand, having an ethics "point-person" runs the risk of triggering a diffusion of responsibility about monitoring ethics issues.

137. Absent some ethics safety-value or guru, people might behave in ways that harken back to the famous Milgram experiments on electric shocks and word pairs. *See* Stanley Milgram, *Behavioral Study of Obedience*, 67 J. ABNORMAL & SOCIAL PSYCHOL. 371 (1963), reprinted with permission in NANCY B. RAPOPORT, JEFFREY D. VAN NIEL & BALA G. DHARAN, ENRON AND OTHER CORPORATE FIASCOS: THE CORPORATE SCANDAL READER 381 (2d ed. 2009) (providing the methodology and results of a behavioral experiment involving fake electric shocks given by participants to actors who pretended to give incorrect answers to word-pairing questions).

138. One risk is that the person who brings a potential ethics problem to the firm's attention might be a chronic complainer or someone who is habitually wrong about ethics issues; there's a risk that encouraging the raising of ethics questions will create too many false positives. Naturally, there has to be some balance between encouraging good-faith behavior and discouraging whining or malicious behavior. Chronic complainers often get tuned out, but in fact having someone who constantly delivers bad news or throws up roadblocks isn't horrible. Often, our own biases prevent us from seeing pitfalls in our thought processes, so having someone who routinely slows down some of our decisions is a good thing. *See, e.g.*, ORI BRAFMAN & ROM BRAFMAN, SWAY: THE IRRESISTIBLE PULL OF IRRATIONAL BEHAVIOR 159–60 (2008) (discussing the use of "blockers"). In general, encouraging full reporting, even if reporting generates false positives, will be good for an organization. *See* Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1176–80 (2013) (citing Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 704 (2011)) (explaining how, within a firm, a disinterested attorney might be able to analyze another attorney's ethical dilemma more objectively). Having an organization "walk the walk" is crucial.

Consider the positive messages sent in the following environment:

> One CEO of a financial services firm was very serious about identifying and rewarding people who lived his organization's values. He challenged his executives to bring him stories of employees who were doing the right things in the right way, who were models of the culture. He collected these stories and sent personal, handwritten thank-you notes to those model employees. While a phone call might have sufficed, employees were so thrilled with his

should also provide regular ethics feedback to its employees, on the order of "in the last quarter, these ethics issues were raised, and here's how we resolved them."[139] By reporting on tough ethics issues regularly, the firm can create a repository of how it has addressed them, and it can demonstrate the social norms—the *ethics* norms—that it wants its professionals to follow.[140]

Let's assume, then, that our hypothetical law firm has made it clear that it wants to encourage ethical behavior and the raising of potentially tricky ethics issues. The first thing that we might want to change involves billable time.

A. *Changing Billing Behavior.*

I'm not a huge fan of the billable hour.[141] Using billable hours as the metric to represent "value to the client" creates bad incentives to stretch out work (and penalizes the more efficient workers). On the other hand, fixed rates and alternative billing methods aren't panaceas, either.[142] But

> written recognition and praise that they displayed his notes in their offices. Those framed notes sent a rather loud message to other employees about what kind of behavior was valued at high levels. Of course, they also helped spread word of the 'heroes' and their deeds.

Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1176 (2013) (quoting LINDA K. TREVIÑO & KATHERINE A. NELSON, MANAGING BUSINESS ETHICS: STRAIGHT TALK ABOUT HOW TO DO IT RIGHT (2007)). Nettie Mann has pointed out to me that the TV show *Undercover Boss* is premised on the idea that high-level executives might not realize what's going on in their own businesses. *See About*, UNDERCOVER BOSS, CBS, http://www.cbs.com/shows/undercover_boss/ about/ (last visited Jan. 13, 2014) ("UNDERCOVER BOSS is an Emmy Award-winning reality series that follows high-level corporate executives as they slip anonymously into the rank-and-file of their own companies. Each week, a different executive will leave the comfort of [his] corner office for an undercover mission to examine the inner workings of [his] corporation.").

139. *See* Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1179 (2013) (promoting the use of feedback as a tool that, when used appropriately, encourages attorneys to report ethical concerns with greater confidence that the firm actually values their reporting).

140. Although that repository might be discoverable (a discussion outside of the scope of this article), it's still likely worthwhile.

141. *See, e.g.*, Nancy Rapoport, *Nancy Rapoport's Blogspot: Death of the Billable Hour*, BLOGSPOT.COM (June 24, 2013), http://nancyrapoport.blogspot.com/search/label/Death%20of%20the%20billable%20hour (blogging on the ethical dilemmas and concerns involved in billable hours).

142. Flat fees might encourage lawyers to do less, not because doing less work is more efficient, but because doing less work is more profitable. And creating a success fee as part of a lawyer's services begs the question of how the lawyer and the client should define "success" for a particular matter. There's no perfect way of measuring the value of a lawyer's service to the client.

the billable hour is particularly susceptible to creating perverse incentives. Firms that measure partner draws or associate bonuses by the number of billable hours above a certain baseline are likely to get some pretty tired people working for them. Not everyone will be motivated by higher draws or by bonuses, but a lot of people will be.[143]

Among the problems with billable hours is the issue of contemporaneous time entry. It's easier to be accurate in recording the amount of time that a professional spends on a matter when the professional notes the time of day at which he started working on a task, the time at which he stopped, and what exactly he did. On very busy days, when he's working a little bit on a lot of different matters, keeping track of how long he spends on each task is difficult—not impossible, just difficult. I'm going to assume that our hypothetical law firm doesn't want any of its

143. Here's what really high billable hours mean:

> A billable hour is time spent working on a legal matter for the benefit of the client. The lawyer who seriously claimed to bill clients for 6022 hours in one year must bill, on average, over 16.5 hours each and every day of 356 days a year. There are only 8760 hours in an entire year. That lawyer is claiming to work more than sixteen hours every weekday and also *every* Sunday and *every* Saturday. He must be in the office working on client matters on Christmas Day, July 4th, December 31st, and January 1st. If he takes even one day off, he has to bill over sixteen hours on some other days, but on each of those other days he was already working over sixteen hours. On average, he has to spend less than eight hours a day to sleep—apparently sleep was not necessary for this lawyer who claimed to have worked all night for fifty-two days (and nights) in a row. Out of the 7.5 hours left in each day, he must not only sleep but also eat, commute to work, read a newspaper, shower and shave, dress himself, take a shower, pay his bills, etc. If he were a prisoner of war instead of a highly paid law partner, the Geneva Convention would forbid him from going fifty-two days without sleep.
>
> When a lawyer claims to work that many hours, one would think that his partners know that something is amiss. However, perhaps his colleagues did not mind the increased income that the law firm earned. The lawyers who overbill may be moving up in the firm pecking order at an above-average rate. The more senior lawyers may close their eyes to what they do not want to see. Other lawyers, particularly the junior associates, may conclude that they should exaggerate their hours if they also wish to climb up the partnership ladder. They may well rationalize what they are doing: "everyone does it;" "I shouldn't reduce my billable hours for the thirty-minute chat with a friend, because I was still thinking about the client;" "I only read this newspaper briefly, and I really did that to see if there is anything that might inspire me about the client, so I'll charge him for my newspaper break."

Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 718–19 (2011) (footnotes omitted).

professionals to cheat on their billable hours,[144] so it's going to want to encourage them to record their time as contemporaneously as humanly possible. One way to encourage accurate and prompt recording is by doing spot checks on someone's work (audits)—and audits might not be a bad idea, although they run the risk of insulting those who work at the firm.[145] An audit would catch the situation in which several people who attended a meeting on a given day recorded different times: for example, Mr. A recorded .9, Mrs. B recorded .4, and Ms. C recorded 1.3. That audit might give the firm notice that something—not necessarily cheating, but something—was amiss (although it's possible that the three professionals came and went at different times). But an audit will only catch certain things, and it will only catch those things after the fact. What we'll want to do is develop either an incentive or a default rule that encourages the contemporaneous recording of time.

My guess is that an opt-out default rule might help—and not just a rule, but something even more concrete: software that forces a person to go through some hoops before he or she can say, "I don't have a billing number that I can use."[146] Just as there are some websites that make you

144. *But see* Lisa G. Lerman, *Scenes from a Law Firm*, 50 RUTGERS L. REV. 2153, 2158 (1998) (providing an account of how a lawyer might defraud clients by creating work and then billing the clients threefold for the contrived services).

> The first lawyer gave me this tip: "You have . . . fifty or sixty files. . . . You need to find a reason to make a telephone call to somebody involved in each file." He said something like: "You think about it, you've got the client, you've got experts, [and] you've got opposing counsel. Think of all the people you can call. Find a reason to call somebody. Make the call. You bill for the call. When you hang up the phone you immediately do a confirmatory letter. Then you bill for the letter. And if the adjuster will let you, you do a memo to the adjuster . . . on what transpired during the call. Then bill for the memo. So you bill three times per call." And he said, "A month shouldn't go by without this happening at least once to every case." In other words, create a reason, and then create a bunch of work to go with it, and it looks like you are just being on top of the situation.

Id.

145. Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 720 (2011) (suggesting that firms should use internal audits as a procedural safeguard against dishonest billing).

146. After all, there are all sorts of products that can jog your memory. A Jawbone Up can let someone set a reminder to stand up and move away from his desk every hour. SwipeSense reminds health care workers to wash their hands. *See* Tom Corrigan, *SwipeSense: Forget to Wash?*, WALL ST. J. (Oct. 7, 2013, 1:57 PM), *available at* http://online.wsj.com/news/articles/SB10001424052702303643304579109790293734458?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052702303643304579109790293734458.html (tracing the origins of the startup company SwipeSense and its system of hand-sanitizer dispensers

enter your email address and password before you can access them, there could be a computer program that forced you to enter a billing number (including a "matter pending" number for matters that haven't been assigned billing numbers yet, or for things like conflicts checks) and a description of your work each time that you opened a new document on your computer. Whenever you switched to a different document, or to a website (for, example, a legal research site), the computer program would ask you whether you were continuing with the same matter (and would prompt you for a fresh description of what you're doing) or whether you were starting something new.[147] Of course, such a program would be annoying as heck, and I'm sure that someone would eventually hack a work-around for it, in much the same way that people hack their need for a matter code when using photocopiers.[148] But it might get folks into the habit of recording their time more contemporaneously.

Such a program might also prevent people from entering meaningless descriptions ("attention to file" has never told a single client what the biller actually did) by preventing anyone from using that description.[149] Instead, it might encourage other types of descriptions, such as requiring the biller to describe the kind of research that he or she was doing whenever the description started out with the word "research," or just what he or she was reviewing or revising if the description started out with the word "review" or "revise." There could be a sort of auto-complete function[150] like the ones that search engines use, where a biller can enter part of a description and the auto-complete could suggest several different ways of finishing that description.[151] In an ideal world, the very same

that track and record the who, where, when, and frequency of hand-washing).

147. No fair stealing this idea. Billie Ellis and I have claimed it, and we really do want to create such a program (assuming that no legal billing software does that already). If you want to consider partnering with us, though, give one of us a call.

148. Hat tip to Walter Effross for reminding me about the work-arounds for inputting client matter numbers into the copier before making copies.

149. It's possible that "attention to file" is an artifact that came from moving from one-line bills ("For services rendered, $*x*") to justifying a bill by describing timed tasks.

150. But without the embarrassing issues created by auto-correct. *See generally* DAMN YOU AUTOCORRECT, www.damnyouautocorrect.com (last visited Jan. 27, 2014) (compiling examples of the multitude of ways in which the use of auto-correct can lead to embarrassing results).

151. For example, the biller could enter "revise," and the system could pull up the various matters on which that biller had already worked, so that the biller could select the document that she was revising (such as "revise summary judgment motion" or "revise schedules").

computer program could help the biller redact sensitive information if such redaction were prudent—for example, if the firm wanted to include its bills in a motion to approve its fees but didn't want to reveal some upcoming strategy.[152] Better yet, if a biller was working on something that had particular rules about how to bill—such as particular billing codes that a client wanted the firm to use—perhaps that program could default to those rules on a given matter. Let's say that you represented a creditors' committee in a large Chapter 11 case, and you wanted some of your non-bankruptcy-group lawyers to work on a particular project. They might not know that it was important to bill in tenths of an hour and to avoid block-billing, but you might be able to include those parameters on the matter number so that when they entered a description that had several different tasks, the program would automatically ask them to use tenths of a hour to indicate how much time they'd spent on each task. The idea here is that telling people to do (or not do) something isn't nearly as good as creating a default rule that requires them to opt out if they want to do something different.[153]

What about that longstanding problem of people who might be recording their time contemporaneously but who can't seem to manage to submit their recorded time on a regular basis? That problem might be solved with a checklist that would prompt administrative assistants[154] to confirm, perhaps when they logged on to the system each morning, that their billers' timesheets had been turned in the day before.[155] Another way to go would be to use a negative incentive, such as docking a person's pay for a day, which would tap into the difference between a perceived loss and a perceived gain. My point is that some things relating to bills can be systematized to make it more difficult to record time several hours, days, weeks, or months after the fact and to make it more difficult to block-bill. We might not currently have the technology to make computer billing

152. I mean it: Billie and I have dibs on this idea. *See supra* note 147 and accompanying text.

153. Walter Effross has pointed out to me that the move to electronic patient medical records might be a good example of an opt-out rule.

154. Although with the burgeoning ratio of billers to administrative assistants, maybe that suggestion isn't realistic.

155. If one of your billers lies and says that his timesheets were turned in when, in fact, they weren't, your firm has bigger problems to solve.

My colleague Jean Sternlight has suggested to me that another option is to have timesheets get submitted automatically after a biller has recorded time—maybe, say, at the end of the day (which could be midnight for many lawyers). Notes on earlier draft from Jean Sternlight to author (Sept. 20, 2013) (on file with author).

systems with these types of opt-out rules, but we certainly could develop them.

The larger issue of weaning law firms away from measuring an attorney's value to the client by counting billable hours, though, doesn't lend itself to simple default rules; however, it might lend itself to some incentives. Fixed fees, especially those that have certain markers—"if we save you *$x,* we get a bonus kicker of *$y*"—are an attempt to realign two concepts: what the law firm does for the client and the value of that work to the client.[156] Such fees provide an incentive to economize, because throwing more billable hours at a problem cuts away at the expected profit. But figuring out the correct fixed fee to charge is tricky, as is any sort of outcome-based fee.[157] Rational people will tend to produce the behavior that leads to rewards, so metrics that are based on, say, quick settlements[158] might cause an attorney to jump at the chance to settle a case even though going to trial might be a better move for the client.[159] The metrics also have to be realistic: defining "success" as "avoiding nuclear holocaust" is too broad a metric to be meaningful. Defining success as "100% return to unsecured creditors, plus interest, in a Chapter 11 case" is much better, although that definition would create its own anchoring errors.[160]

A particular hiccup will occur if some of the firm's work is charged out based on billable hours and some of it is based on fixed fees or some other alternative billing method. Those employees whose performance and compensation are measured primarily on their billable hours will have a hard time shifting gears for the work that they do on fixed-fee projects, because every hour "not billed" is an hour fewer to plug into their compensation formula. The only way to alter a preference for billable

156. *But see Posts on Death of the Billable Hour*, NANCY RAPOPORT'S BLOGSPOT, http://nancyrapoport.blogspot.com (follow "Death of the billable hour" hyperlink under Labels list) (last visited Jan. 27, 2014) (noting that the billable hour was created because the old method of "$*x* for services rendered" provided the client with little information to determine the value of the services that the client had received).

157. The posts on December 5, 2012 discuss the fact that hourly billing is a problem that has not yet been solved. *Id.*

158. Or success fees, or any other manner of outcome that can be defined to include virtually any result.

159. There's probably research out there that links fast settlements to contingency fees, but I haven't spent time looking for any.

160. For example, paying attention only to the return to unsecured creditors at the plan confirmation stage might mean that issues relating to long-term feasibility would get shorter shrift.

hours, then, is to change the method for calculating compensation. Moreover, when partner compensation is calculated in part on origination (who brings the business into the firm), in part on billable hours (or realization rate), and in part on alternative billing methods, then you have multiple incentives working against each other.

One possible alternative, as long as the firm is using billable hours for any part of its evaluation or compensation structures, is to come up with "billable hour equivalents" for work that's billed on fixed fees or based on benchmarks. For example, a firm could take a fixed-fee matter and estimate the various billers' billable hours associated with that fixed fee. If the pricing for the fixed-fee matter was based on Partner Pat working around 250 hours and Associate Aja working around 400 hours, the "guesstimated" hours could go into Pat's and Aja's yearly "hourly" totals.[161] The risk when using billable hour equivalents, though, is that law firm budgets are based on a certain amount of money coming into the firm each year from the work that the firm does. Projects based on billable hours have some wiggle-room built in—if the matter that the firm has undertaken suddenly explodes, then assigning more lawyers to the matter doesn't necessarily chip away at the firm's expected profit on the matter.[162] On a fixed-fee matter, though, those extra hours absolutely do chip away at the firm's expected profit, because the unanticipated extra hours are being deployed without additional compensation. If a firm bases a large part of its budget on fixed-fee projects but consistently guesses wrong on pricing, then it's not going to make its budget for the year. There's no easy solution here.

B. *Changing Staffing Decisions*

Nor is there any easy solution to encourage partners to think long and

161. "Guesstimating" how many billable hours something might take likely is part of how a firm arrives at a fixed fee proposal. In order to calibrate the accuracy of such guesses, the firm might keep track of billable hours for projects even when those projects are being billed on a fixed-fee basis. It's a bit like adding fractions with different denominators: first, you figure out what multipliers will create fractions with the same denominators, and then you add the fractions together. *See, e.g.*, *Fractions*, COOL MATH 4 KIDS, http://www.coolmath4kids.com/fractions/fractions-12-adding-subtracting-different-denominators-01.html (last visited Jan. 27, 2014) (simplifying the process of adding and subtracting different denominator fractions).

162. *Cf.* Nancy B. Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, 5 J. BUS. & TECH. L. 263, 288 (2010) (acknowledging that fixed fees can't adjust to address an unanticipated amount of work, which might result in a lawyer essentially finishing up a project for free).

hard about how they staff matters.[163] Especially in "bet the company" issues—like a large Chapter 11 case, or big patent litigation, or a tricky initial public offering—there's a tendency to leave no stone unturned.[164] Part of the reason is that the lawyers working on the matter don't want to be accused retrospectively of failing to do everything that they could have done to further the client's cause.[165] Another part of the reason is that many of these big "bet the company" matters are exceptionally fast-paced, so the time that a partner might take to plan out the optimal staffing is compressed.

If we use what we know about perceived losses versus perceived gains—that people give perceived losses roughly twice as much weight as perceived

163. Staffing decisions have long-term ramifications:

> "I've discontinued using firms and shifted to other firms when I've looked at bills that are clearly just billing and not providing value. Whenever I see a partner billing regularly a couple of hours every bill for things like reviewing correspondence—whenever there are a lot of people touching the file and docketing," says Cheryl Foy, university secretary and general counsel with the University of Ontario Institute of Technology.

Jennifer Brown, *More In-house Cutting Firms Loose: Study*, CANADIAN LAWYER MAGAZINE (Sept. 16, 2013), *available at* http://www.canadianlawyermag.com/4816/more-in-house-cutting-firms-loose-study.html; *see also* Jennifer Smith, *Smaller Law Firms Grab Big Slice of Corporate Legal Work*, WALL ST. J. (Oct. 22, 2013), *available at* http://online.wsj.com/news/articles/SB10001424052702303672404579149991394180218 ("'Not everything is a bet-your-company kind of case, and not every case warrants the big guns from New York,' Mr. Milstein [Ronald S. Milstein, general counsel for Lorillard Inc.] said. 'Smaller firms—they want you more, they value you more.'")

164. For a lovely discussion of ethics and psychology, see JENNIFER K. ROBBENNOLT & JEAN R. STERNLIGHT, PSYCHOLOGY FOR LAWYERS: UNDERSTANDING THE HUMAN FACTORS IN NEGOTIATION, LITIGATION, AND DECISION MAKING 385–416 (2012).

165. Psychologists might term this tendency to leave no stone unturned "regret aversion." *See, e.g.*, *id.* at 99–100 ("When making decisions, people anticipate the prospect that they will experience regret following the decision[and] . . . make decisions that they think will avoid or minimize the amount of regret that they expect to feel."). Others may just point to the fear of being sued for malpractice for not pursuing every legitimate avenue. Of course, the client who is paying the bill from his own budget will usually weigh in, when it questions the law firm's bill, about where the law firm should have drawn the line about how much work to do.

Clients who aren't paying for their own fees have been of particular interest to me. *See, e.g.*, Nancy B. Rapoport, *The Case for Value Billing in Chapter 11*, 7 J. BUS. & TECH. L. 117, 118 (2012) (explaining that the author became an "occasional fee reviewer" in bankruptcy cases); Nancy B. Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, 5 J. BUS. & TECH. L. 263, 265 (2010) ("In essence, the client sitting at the table is a stand-in for entities with little voice (and little individual stake) in determining how the professional makes his billable decisions.") (citation omitted).

gains[166]—then maybe we can fashion a way to encourage better staffing decisions. Let's assume that a client asks a law firm to propose how it might staff a particular matter, and the client agrees to the proposed staffing.[167] Perhaps some component of the bill (not the entire bill, but some significant component) might be tied to maintaining that proposed staffing, absent client consent to a change. There would have to be a safeguard for significant changes in the original presumptions underlying the staffing—for example, that the law firm on the other side was engaging in some sort of obstreperousness that ramped up the work for everyone. But if a law firm expects that a matter might bring in somewhere between $\$x$ and $\$y$ with a certain amount of staffing, and if adding more lawyers without client consent reduces the expected profit for the law firm, then the perceived loss might cause the partner in charge to think twice (or get client consent) before changing the staffing.[168] Of course, the perceived loss of the ability to staff a matter any way that a partner might deem appropriate will cause serious resistance to default rules on staffing levels.[169]

Default rules on how to staff certain types of matters *might* fix the "too

166. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 57 (2009).

167. In thinking about issues like fees and staffing decisions, the level of trust between an attorney and her client is significant. For clients who use lawyers often, the choice of law firm tends to be more of a choice of a particular lawyer or lawyers (which is why a lawyer's book of business matters so much). Even though I'm suggesting changes that might help lawyers think more carefully about how they bill their work and how they staff their matters, ultimately, the client has to believe that the lawyer's fees and staffing decisions make sense for that client's needs.

168. We could even go as far as creating form engagement letters that set out default staffing for particular types of engagements, so that changing the defaults would have to be an affirmative act. Hat tip to Dustin Benham for suggesting this idea to me. E-mail from Dustin Benham to author (Oct. 10, 2013, 01:31 PM) (on file with author).

169. That's where compensation measures that include more than "yearly billable hours" can help to clarify the need for a change. By comparing "revenue in" with "costs of generating that revenue," a very different picture can emerge. As the chair of Duane Morris explained:

> Many firms just look at the size of each person's book of business. They'll say, "Okay, you have $4 million worth of business, Julia has $4 million worth of business, Robert has $4 million worth of business, you all ought to be compensated the same off your $4 million worth of business." But, in reality, your $4 million worth of business took six people to produce, and you generated time value of $3.5 million in producing $4 million. Julia's $4 million took $4.5 million worth of time value and 10 people. Robert's $4 million took $7 million to produce, and it took 20-some people. So the costs and value are entirely different, and that would drive different partner compensation.

Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 9 (July 26, 2013).

many bodies added" problem, but they won't fix the "I didn't think about the right staffing in the first place" problem. Nor will they fix the "we're not making budget so let's shift the work to higher billers" problem. We don't want to create an irrebuttable presumption that certain work always must go to low- (lower-?) level associates, but if we could find a way to encourage a presumption that work should go to the lowest *efficient* biller, then we wouldn't need to object to very high-level work going to the people charging high rates—provided that they were only doing the work that needed their special expertise. In other words, I want my knee doctor to figure out the best way to treat a bum knee, but I don't want him putting the cast on me himself—that's why he has other trained people in his office. I believe that most lawyers who head projects for their clients want to allocate staffing appropriately, but I also believe that various things get in their way: the speed of law practice again comes to mind, as do all of the cognitive biases to which humans succumb.[170] To counteract the effect of the speed of practice and the fact that humans make cognitive errors all the time, maybe what we need is a combination of a checklist ("1. Clear conflicts; 2. Fill out staffing worksheet; 3. Draft engagement letter") and a worksheet that will help the lead lawyer rough out who at the firm should be handling which tasks. Much like an application for an order authorizing employment in a bankruptcy case,[171] the lead lawyer on a matter could describe for the client which professionals—including paralegals—would be working on that matter. That roadmap, agreed upon by the firm and the client, would turn a gut hunch about appropriate staffing into a more deliberate consideration of staffing.

C. *Changing Cross-Selling*

It's usually better for a firm's bottom line to keep a new matter for an old client in-house than it is to lose that matter to another law firm and then have to scramble to get replacement clients.[172] So what stops

170. Jennifer Robbennolt and Jean Sternlight have a nice discussion of cognitive biases in JENNIFER K. ROBBENNOLT & JEAN R. STERNLIGHT, PSYCHOLOGY FOR LAWYERS: UNDERSTANDING THE HUMAN FACTORS IN NEGOTIATION, LITIGATION, AND DECISION MAKING 7–27 (2012).

171. *See* 11 U.S.C. § 327 (2012) (providing rules for employment of professional persons).

172. On the other hand, it might be better for an individual lawyer in a firm to cross-sell with a colleague at a different firm, particularly if that lawyer believes that the outside-the-firm lawyer is

partners from trying to refer matters to other partners within their firm? Their compensation.[173] This passage illustrates the issue nicely.

> There was frustration with other aspects of the new compensation system, too. Previously, partners were reluctant to ask colleagues to help on their pitches, because credit was a zero-sum game: If a partner landed the business, she would have to award some of the credit to the colleague, leaving less for herself. Under the new rules, the firm allowed the partner to claim up to 100 percent of the credit herself, then dole out up to 100 percent more among any partners who had helped.
>
> This encouraged collaboration at times, according to several former partners. The downside was that many began to view the additional 100 percent worth of credit as a slush fund, ladling it out to friends with little role in their cases or transactions. "It led to sleazy deals," recalls one former partner. "It took about thirty seconds for people to figure it out." Says a former finance lawyer of two senior partners in his group: "I saw the billing going around. One was getting credit on stuff the second opened, and the second was getting credit for stuff the first one opened." There seemed to be no way around it: The more Mayer Brown set out to fix its problems, the more deviously its partners behaved.[174]

I might not have chosen the word "deviously," but I agree that humans will respond to the incentives that they're given. Mayer Brown may have tried to fix the original problem—not sharing any of the origination credit—with its creative idea of allocating more than 100% "credit" across partners, but that fix created its own problems.[175]

Maybe there's another way to approach the issue of cross-selling. If a firm wants to reward cross-selling, then the act of cross-selling has to count for part of a partner's compensation.[176] In a recent *Harvard Business Review* case study, the Duane Morris law firm explained its way of

---

better suited for a particular matter but also if the inside-the-firm lawyer wants to keep her own options open for a subsequent lateral move.

173. The other thing that affects partners' willingness to cross-sell is their own concerns about career mobility. As Randy Gordon has explained to me, "partners want to keep their portables portable," so there's an incentive not to share the wealth, as it were. E-mail from Randy Gordon to author (Sept. 23, 2013, 01:11 PM) (on file with author).

174. Noam Scheiber, *The Last Days of Big Law: You Can't Imagine the Terror When the Money Dries Up*, NEW REPUBLIC (July 21, 2013), http://www.newrepublic.com/article/113941/big-law-firms-trouble-when-money-dries (footnote omitted).

175. *See, e.g.*, *id.* (describing the process used by the firm).

176. And, if we're feeling particularly nurturing towards associates, towards an associate's bonus. After all, we want to train associates in the behavior that they'll need as partners, right?

measuring a lawyer's value for compensation purposes:

> Partners told Harvard business professor Heidi Gardner and her researcher that Duane Morris doesn't pay outsize compensation for being a rainmaker, and doesn't pay based on billable hours alone. The system encourages collaboration rather than fights over origination credit and the hogging of work.
>
> The compensation calculation begins with metrics that show the profitability of each lawyer.
>
> Attorney profitability is calculated by comparing the revenue collected on a lawyer's matters with the costs of that lawyer, measured by the lawyer's salary and overhead, according to the case study. If Attorney X earned $200,000 and cost $190,000 in overhead, Attorney X's costs to the firm for the year were $390,000. If X worked 2,000 hours, the cost per hour worked out to $195. The findings can then be used to see whether X was more or less profitable than he should be.
>
> Duane Morris chairman John Soroko told Harvard researchers why the numbers were important. "Many firms just look at the size of each person's book of business," he said. They see three lawyers with $4 million worth of business, and compensate all of them the same for their rainmaking, he said. But those firms aren't looking at the costs and value associated with that business, he said.
>
> The profitability calculation primarily drives pay, but the executive committee looks at other factors, taking into account a self-evaluation memo written by each lawyer. Mentoring, administrative roles, the ability to generate new business, internal referrals, the efficiency of the partner's team, attitude and work habits enter into the calculation. Any partner may see the full array of compensation information, though "remarkably few" ask to see the numbers.
>
> Partner Sharon Caffrey told researchers that the compensation system doesn't overemphasize rainmaking. "There is a balance between rainmaking and work effort," Caffrey said, "so we don't have a lot of rainmakers with huge books of business receiving credit disproportionately, who then have many service partners who do not receive credit for helping the rainmakers achieve success."[177]

177. Debra Cassens Weiss, *BigLaw Firm Reveals Nuts and Bolts of its Pay System in Harvard Case Study on Collaboration*, ABA J. (Oct. 15, 2013, 5:40 AM), http://www.abajournal.com/news/article/biglaw_firm_reveals_nuts_and_bolts_of_its_pay_system_in_harvard_case_study/?utm_source=feedburner&utm_medium=feed&utm_campaign=ABA+Journal+Top+Stories; *see also* Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*,

That Duane Morris has developed a way to quantify the various ways that a lawyer's work contributes to the firm's bottom line demonstrates both that this type of evaluation can be done and that it should be done. If our hypothetical law firm were to follow Duane Morris's lead, then perhaps our compensation system could also include points for demonstrating specific actions that a lawyer took, not just to get new clients or new matters, but to maintain long-term client relationships across departments.[178] Remember: people will do that for which they're rewarded. Reward cross-selling, and you'll get more of it.

D. *Changing Time Spent in, and the Quality of, Mentoring*

The same is true about nurturing associates.[179] Associates are expensive:[180] For the first few years, most of them will get paid more than they'll actually generate.[181] Moreover, if a law firm loses an associate whom it has trained for two or three years, then it watches hundreds of

HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 9–10 (July 26, 2013) (examining the compensation system employed by Duane Morris).

178. Or maybe, in a more Hobbesian type of firm, we could use the concept of perceived losses to our advantage and take away points if a partner can't document the efforts that she's made to cross-sell within the firm. Of course, it will matter whether what's being measured represents "inputs" (what a lawyer has done to maintain the relationship with the client) or "outputs" (whether the client has actually stayed with the firm). Just as *U.S. News & World Report's* educational ranking system tends to focus more on inputs (test scores and GPAs) than on outputs (bar passage and employment rates), which in turn drives the behavior of law schools to game the rankings, how a firm measures certain behavior will also trigger increases in the frequency of that rewarded behavior. *Cf.* Sam Flanigan & Robert Morse, *Methodology: Best Law Schools Rankings*, U.S. NEWS (Mar. 11, 2013) http://www.usnews.com/education/best-graduate-schools/top-law-schools/articles/2013/03/11/methodology-best-law-schools-rankings (discussing the formula for ranking law schools).

179. Dave McGowan has pointed out to me that there's a whole new issue brewing: the mentoring of contract and temporary attorneys. Without the umbrella of a long-term career trajectory to drive an associate's training, how do we develop these new classes of lawyers? That's a topic for another time.

180. Back when BigLaw had huge summer associate programs, the amount of attention paid to those summer associates—and the expense of those programs—was astounding. To be fair, though, those days of two-hour lunches and box seats at ballgames occurred at firms that also invested heavily in associate training (and didn't charge out all of the associate training to clients).

181. *See* James D. Cotterman, *The Changing Face of Associate Compensation*, 37 ALTMAN WEIL REP.TO LEGAL MGMT., no. 9, June 2010, at 1, 2 (comparing the associates' salaries to the revenue that they bring to the law firm); *see also* Bos. Bar Ass'n Task Force on Prof'l Challenges and Family Needs, *Facing the Grail: Confronting the Cost of Work-Family Imbalance* at 29 (1999) ("Only after three o[r] four years do associates' billing rates and legal skills catch up to their salaries, benefits and allocated overhead so that they begin to return the firm's financial investment in them.").

thousands of sunk costs walk out the door.[182] It's in law firms' interests to (1) make good initial hiring decisions and (2) establish an environment conducive to retaining those good hires.[183]

I've tried for years to encourage law firms to make better hiring decisions, but far too many of them stick with the twin factors of the law school's ranking and the applicant's class rank.[184] No matter how many times I remind employers that the chances are slim that their new associates will have to take any law school exams for their clients, I can't get employers to look at the other skills that their associates will actually need to have. Sure, grades might do a decent job of sorting people into those who have strong analytical skills and decent writing skills versus those who don't, but there are many additional skills that associates will need if they intend to succeed in law firms.[185] And grades are typically comparative in law schools—grading curves only describe how well someone has done relative to his peers in a given course—rather than being

182. *See, e.g.*, PAULA A. PATTON, KEEPING THE KEEPERS II: MOBILITY & MANAGEMENT OF ASSOCIATES (2003) ("When a law firm is unable to retain the 'keepers,' it may lose more than profits from the bottom line.").

183. *See* Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 3–4 (July 26, 2013) (describing Duane Morris's hiring philosophy).

184. I hear from reliable sources that law firms focus on these two factors for a couple of reasons: first, firms don't want to take the time to select potential employees if law schools can do the selecting for them, and second, the higher the associate's pedigree, the easier it is for the firm to justify the associate's billing rate to clients ("Yes, I know that we're charging $370 [per] hour for someone who has no particular experience doing anything, but just look at where she went to school!"). *Cf.* Debra Cassens Weiss, *BigLaw Firm Reveals Nuts and Bolts of its Pay System in Harvard Case Study on Collaboration*, ABA J. (Oct. 15, 2013, 5:40 AM), http://www.abajournal.com/news/article/biglaw_firm_reveals_nuts_and_bolts_of_its_pay_system_in_harvard_case_study/?utm_source=feedburner&utm_medium=feed&utm_campaign=ABA+Journal+Top+Stories (explaining how some firms recognize the value in collaborative skills).

185. I'd be remiss if I didn't insert some shameless self-promotion here. My husband and I have a new book out that discusses the various skills that lawyers will need to succeed in law firms. *See generally* NANCY B. RAPOPORT & JEFFREY D. VAN NIEL, LAW FIRM JOB SURVIVAL MANUAL: FROM FIRST INTERVIEW TO PARTNERSHIP (2014) (discussing the different skills necessary for success as a lawyer). I've also suggested that law schools could use some version of the twenty-six "Berkeley Factors" to rethink legal education. *See* Nancy B. Rapoport, *Rethinking U.S. Legal Education: No More "Same Old, Same Old"*, 45 CONN. L. REV. 1409 (2013) (advocating for the use of the factors); *see also* Marjorie M. Shultz & Sheldon Zedeck, *Predicting Lawyer Effectiveness: Broadening the Basis for Law School Admission Decisions*, 36 LAW & SOC. INQUIRY 620, 630 (2011) (discussing the Berkeley factors).

absolute measures of talent. If I could persuade a law firm to hire based on performance in responding to a hypothetical issue rather than to a person's school or class rank, I'll bet that the firm could avoid some hiring mistakes (those involving people with good grades but poor "soft skills").[186] But that's a battle that I'm going to have to keep fighting.

Law firms have realized, though, that they need to invest in their associates in order to retain them.[187] For example, law firm efforts to increase the retention of women and people of color have developed in response to studies that women and lawyers of color tend to leave BigLaw in disproportionate numbers.[188] The savvier law firms have created "core

186. Clifford Chance recently announced that it was changing the way that it screened job applicants:

> Clifford Chance, one of the big five "magic circle" law firms in the United Kingdom, has quietly introduced a "CV blind" policy for final interviews with all would-be recruits. Staff conducting the interviews are no longer given any information about which university candidates attended, or whether they come from state or independent schools.

Richard Garner, *Law Firm Clifford Chance Adopts 'CV Blind' Recruitment Policy to Break Oxbridge Recruitment Bias*, THE INDEPENDENT (January 9, 2014), http://www.independent.co.uk/student/news/exclusive-law-firm-clifford-chance-adopts-cv-blind-policy-to-break-oxbridge-recruitment-bias-9050227.html.

187. My friend Matt Bruckner has pointed out that the failure to train junior associates in some law firms may represent a market response to the expense of training them—if they're going to leave anyway, why invest in improving the very skill sets that will make them more attractive elsewhere?

188. *Compare Women in Law in the U.S.*, CATALYST KNOWLEDGE CTR. (Mar. 11, 2013), http://www.catalyst.org/knowledge/women-law-us (providing statistics on women in law school, law administration, and those employed in law firms), *with Law Firm Diversity Wobbles: Minority Numbers Bounce Back While Women Associates Extend Two-Year Decline*, NAT'L ASS'N FOR LAW PLACEMENT (Nov. 3, 2011), http://www.nalp.org/2011_law_firm_diversity (illustrating the number of women and minorities in law firms), *and* MONA HARRINGTON & HELEN HSI, WOMEN LAWYERS AND OBSTACLES TO LEADERSHIP: A REPORT OF MIT WORKPLACE CENTER SURVEYS ON COMPARATIVE CAREER DECISIONS AND ATTRITION RATES OF WOMEN AND MEN IN MASSACHUSETTS LAW FIRMS 6–7 (2007), *available at* http://web.mit.edu/workplacecenter/docs/law-report_4-07.pdf (providing data on men and women's career choices in Massachusetts).

I hope that law firm efforts in this regard aren't just window-dressing.

> It is easier to appoint a diversity officer [to comply with affirmative action requirements] than to change hiring practices deeply embedded in both individual and institutional beliefs and practices. Since the presence of a diversity officer is more visible than revisions in hiring priorities, the addition of a new role may signal to external constituencies that there has been improvement, even if, in reality, the appointment is a formality and no real change has occurred.

LEE G. BOLMAN & TERRENCE E. DEAL, REFRAMING ORGANIZATIONS: ARTISTRY, CHOICE, AND LEADERSHIP 299–300 (4th ed. 2008).

competencies" that they want their associates to have, subdivided by practice group and years of experience.[189] Knowing the skills that you want your associates to acquire is important. Making sure that the people are assigning work to those associates to maximize their exposure to those skills is just as important, and that's where the gap between wanting to mentor associates and getting people to take time to mentor them can widen.

Let's go back to incentives. People may really, really want to mentor associates, but they can easily put that desire on a back burner when other incentives compel them to put other things first—namely, service to clients. Mentoring becomes something that a senior lawyer "should" do, rather than something that a senior lawyer takes time to do, especially if that senior lawyer has many matters, each of which could take several hours of very long days to do.[190] That senior lawyer is not going to add a twenty-first hour to a twenty-hour day to meet with a mentee to see if she is getting a variety of work experiences.

In the old days,[191] senior lawyers mentored junior ones in part by making sure that they sat in on a wide variety of tasks before they were asked to "solo" on them. It's my understanding that the billing attorneys

189. *See Firmwide Core Competencies*, VINSON & ELKINS (Nov. 7, 2013), *available at* http://www.velaw.com/uploadedFiles/VEsite/Careers/firm_core_comp.pdf (listing the qualities that the firm expects from associates); *see also Creating a Path to Success*, BAKER BOTTS, http://www.bakerbotts.com/professionaldevelopment/ (last visited Jan. 8, 2014) (referring to its competency model based on a "series of four progressive levels"); *cf.* Bryn R. Vaaler, *Codifying Competencies, Law Firm Partnership & Benefits Report*, DORSEY & WHITNEY (Jan. 2005), http://www.dorsey.com/newsevents/uniEntity.aspx?xpST=PubDetail&pub=2205 (explaining Dorsey & Whitney's model). As a way of retaining valuable employees, many firms have also tried to figure out the thorny issue of "part-time" legal work, in order to give people with caregiving responsibilities a shot at some work/life balance. The problem with trying to design a system that allows for significant work/life balance is that the pacing of legal work ebbs and flows, so that predictable schedules that would allow things like part-time work and job-sharing are difficult to maintain. On the other hand, contract attorneys trade a chance for partnership and the development of a wide variety of experiences for a more predictable schedule, so there *are* work-arounds. Unfortunately, many of those work-arounds don't lend themselves to a normal progression on a partnership track.

190. I have, however, spoken to a number of senior lawyers who are happy to take the time to serve as mentors, in large part because they themselves were mentored and they saw how much they learned from the mentoring that they received. The problem with law firms that don't have a culture of mentoring is that they will create future generations of lawyers who weren't mentored and don't see the benefit of serving as mentors themselves.

191. In other words, when I was an associate.

wrote off much of that observation time. It's also my understanding that law firms now neither provide significant observation experience nor write off as much time as they used to; moreover, those clients with good bargaining power are starting to refuse to pay for first- and second-year associate time.[192] So what's a law firm to do?

One law firm has launched a "residency" program that will pay some first-year associates a smaller salary in exchange for more training and a smaller billable hours requirement.[193] Given the current bad job market for newly minted lawyers, that approach is likely more palatable to firms (if not to those associates who get the lower salary) than is any suggestion that partners cut the amount of their draws to fund increased mentoring.[194]

192. *See, e.g.*, Ashby Jones & Joseph Pallazzolo, *What's a First-Year Lawyer Worth?*, WALL ST. J. (Oct. 17, 2011), http://online.wsj.com/article/ SB10001424052970204774604576631360989675324.html?mod=ITP_marketplace_0 ("According to a September survey for The Wall Street Journal by the Association of Corporate Counsel, a bar association for in-house lawyers, more than 20% of the 366 in-house legal departments that responded are refusing to pay for the work of first- or second-year attorneys, in at least some matters. Almost half of the companies, which have annual revenues ranging from $25 million or less to more than $4 billion, said they put those policies in place during the past two years, and the trend appears to be growing.").

193. *See* Debra Cassens Weiss, *'Residency Program' Associates at This BigLaw Firm Will Get More Training and Less Pay*, ABA J. (Oct. 22, 2013, 7:48 AM), http://www.abajournal.com/news/article/residency_program_associates_at_this_biglaw_firm_will_get_more_training_and/?utm_source=feedburner&utm_medium=feed&utm_campaign=ABA+Journal+Top+Stories (describing Greenberg Traurig's new residency program); *see also* Sara Randazzo, *Calling All Unemployed Law Grads: Greenberg Is Hiring*, AM. LAW. DAILY (Oct. 21, 2013), http://www.americanlawyer.com/PubArticleALD.jsp?id=1202624550961&Calling_All_Unemployed_Law_Grads_Greenberg_is_Hiring#ixzz2iSbgFuze ("Firm leaders [at Greenberg Traurig] envision the program as a way of recruiting talented associates it wouldn't have hired during the traditional on-campus interview process for one reason or another. It will also allow the firm to assign junior lawyers to client matters without billing their work at the usual cringe-inducing hourly rates."); Lawrence M. Solan, *Pay Associates Less? A Novel Response to a Rapidly Changing Legal Market*, HUFFINGTON POST (Jan. 22, 2013, 1:08 PM), http://www.huffingtonpost.com/lawrence-m-solan/pay-associates-less-a-nov_b_2527419.html ("If clients are not willing to pay top dollar for the work of inexperienced associates, hire the associates at lower salaries, and give them substantial raises as their value increases."). Apparently, those associates hired on the "residency" track at Greenberg Traurig will be hired on a one-year trial basis. *See* Sara Randazzo, *Calling All Unemployed Law Grads: Greenberg Is Hiring*, AM. LAW. DAILY (Oct. 21, 2013), http://www.americanlawyer.com/PubArticleALD.jsp?id=1202624550961&Calling_All_Unemployed_Law_Grads_Greenberg_is_Hiring#ixzz2iSbgFuze (writing on the trial-basis employment); Dan Slater, *At Law Firms, Reconsidering the Model for Associates' Pay*, N.Y. TIMES (Apr. 1, 2010, 1:17 AM), http://dealbook.nytimes.com/2010/04/01/at-law-firms-reconsidering-the-model-for-associates-pay/ (exploring the transformation in how law firms train and hire associates). Hat tip to Dustin Benham.

194. The idea that partners are going to be willing to take less money has about as much of a chance as suggesting that law professors are going to agree to cut their own salaries to make law school a better value proposition for students. *Cf.* Paul Caron, *Washington U. Dean Syverud Tells ABA Task Force: Law Profs, Deans Are Paid Too Much; 50% Pay Cut Would Solve Problem*, TAXPROF

One way or another, though, something has to give—law schools can't rely on law firms to train their graduates; law firms don't have the budget to train their graduates the way that they used to (with shadowing); and those unhappy associates who are able to switch jobs will leave if their careers aren't developing apace.

In our hypothetical law firm, we'd need to come up with incentives that would do two things: encourage senior lawyers to mentor junior ones (by giving them good career advice) and encourage senior lawyers to act as sponsors of those junior lawyers (by suggesting that the junior lawyers get specific types of experience, like speaking on a big continuing legal education panel or staffing a matter to get experience doing tasks that they've not yet completely mastered). Staring us in the face, though, is the fact that time is a zero-sum game. There are simply not enough hours in the day for most lawyers to spend a significant time mentoring their associates.

One possibility that comes to mind is to make more use of those senior lawyers who are no longer partners.[195] Senior "Of Counsel" lawyers have decades of valuable experience[196] and likely have reached a stage in their careers at which their advice and training would provide some serious "bang for the buck"—as long as their mentoring consists of more than just talking about the good old days.[197] Our law firm could establish a cadre of very senior lawyers with some time to spare and some funding for those lawyers to develop training programs for their junior colleagues. The diversion of some budget dollars to that purpose might be dollars that are very well spent.[198]

BLOG (Aug. 11, 2013), http://taxprof.typepad.com/taxprof_blog/2013/08/washington-u-.html (discussing faculty costs in law schools).

195. Of course, asking lawyers to do more mentoring is no assurance that those mentors will be good at mentoring or that mentoring will actually encourage more associates to stay with the firm.

196. And often a more flexible schedule.

197. I'm envisioning something like an in-house National Institute for Trial Advocacy program, run by these very senior lawyers, in the various practice groups.

198. A related issue is the mentoring of summer associates. Again, the zero-sum effect of having only twenty-four hours in a day means that very busy lawyers are going to RSVP to summer associate events and then become no-shows. They're going to invite a summer associate to lunch, once, and then forget all about him or her. Even though summer associate programs are shrinking, they're still an important pipeline for law firm recruiting, and they have the advantage of letting summer associates demonstrate more of their skills during a longer period than the one-day, on-site interview can glean. Although I can't think of many ways to encourage more interaction with

Another possibility is to create several categories of "billable hour equivalent" activities,[199] all of which get factored into a professional's compensation.[200] Such a calculation could involve categories like this:

Billable hour work (and probably the amount collected, not just billed, to factor in[201] the value of the work to the client)[202]	Fixed-fee work (probably by using some calculation of the amounts budgeted for the work or by tracking the actual hours billed)	Contingency fee work	Work on behalf of the firm (committee work, mentoring)

The firm would have to create weights for the various categories, as well as definitions of each type of service to the firm,[203] and it would have to be

summer associates, other than a tracking system that relates "time spent at summer associate events" (and paying attention to the summer associates at those events, rather than spending time in a corner checking email) to points for partnership levels, savvy firms need to think hard about whether having a summer associate program with limited participation by the firm's lawyers is really worth the effort.

199. Notes on earlier draft from Jean Sternlight to author (Sept. 20, 2013) (on file with author).

200. A law firm's decision to compensate activity that doesn't directly generate income requires the firm first to decide that profitability isn't the only goal that it wants to pursue. Many firms make that decision. The question (whether it's about profitability specifically or about other goals) is always whether the incentives that the firm puts in place actually elicit the behavior that the firm wants to encourage.

201. Factoring in "collected" and not "billed" hours is at least a rough approximation of the value of the work to the client, although the amounts collected will also be affected by the client's leverage with the firm and the client's solvency.

202. Take a look at Duane Morris's Matter Contribution Analysis (MCA):

> Duane Morris first developed its matter contribution analysis (MCA) system in 1992. It was a quantitative system used to calculate profitability by client, matter, or individual attorneys. The MCA became the basis of the firm's quantitative analysis for compensation. The system was unusual among firms in that it tracked attorney revenue to the level of individual profitability, not just hours billed.

Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 8 (July 26, 2013); *see also supra* note 68 for a discussion of calculating those individual profitability numbers.

203. For example, what's "mentoring"? Is it having an associate shadow a senior lawyer and ask questions about what the lawyer is doing, after which the senior lawyer critiques the associate's own efforts at the same tasks? Is it having the senior lawyer make sure that the associate gets a varied set of

careful that those weights were significant enough to nudge the desired behavior. For example, weighing mentoring at 0.001% isn't going to nudge anyone to do more mentoring. Weighing mentoring at 10% might. Different lawyers might even negotiate the weights given to their various activities before the start of a new fiscal year, reflecting their relative availability for non-income-producing work and the type of income-producing work (billable hour, fixed-fee, contingency fee) that they generally do. As long as the firm could figure out a way to maintain a certain minimum profit each year, it might be willing to experiment with ways to "count" non-income-producing activity that it wanted to encourage.

E. *Changing the Amount of Time Dedicated to Certain Non-Billable Activities*

> *In a typical day, it takes a lawyer more than eight hours of time to work eight billable hours. For example, the lawyer cannot charge for time spent on law firm committee work or similar administrative matters. The partner cannot bill a client for the time he discusses with his partners what should be that year's bonus for a given associate. This partner will spend time on continuing legal education, a bar meeting, or client development. That is not billable either. When the lawyer is eating lunch, taking a coffee break, chatting with a colleague about last night's baseball game, or using the restroom, that is not work that he can bill to any client.*[204]

Just as there are duties that any professor must undertake even though such duties take away from teaching and research (so-called "service" activities), there are duties that every lawyer must do that aren't billable to a client. Paramount is the duty to do *pro bono* work,[205] but there is also

experiences each year? Or is mentoring success measured by whether the associate succeeds in his or her career over time? And if associate success is the benchmark, must the associate be successful at the firm that was busy mentoring the associate, or is general career success a way to measure the quality of the mentoring? (Don't ask me how one might measure how much the mentoring contributed to an associate's skill set, as compared to the associate's innate talent or work ethic. I have no idea.)

204. Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 718 (2011).

205. *See* MODEL RULES OF PROF. CONDUCT R. 6.1 (2013) ("Every lawyer has a professional responsibility to provide legal services to those unable to pay. A lawyer should aspire to render at least (50) hours of *pro bono* publico legal services per year.").

committee work, networking, participation in the countless surveys that law firms seem to get, and the all-important training of junior lawyers. None of this work "counts" as billable time, and, therefore, much of this work often gets pushed aside.

But one of the best ways to make it count is, well, actually to count it—or at least some of it. When I was at a BigLaw firm, *pro bono* time counted as "billable" time, and the law firm took pains to let it be known that some people billed hundreds, or even over a thousand, hours a year doing *pro bono* work. At least one of my friends there became a partner even though he had billed over a thousand hours of *pro bono* time in one of the years leading up to his partnership. Part of the reason that state bars and the ABA create awards to recognize *pro bono* work is to encourage more people to do it, and to do more of it. To me, the single best way to encourage *pro bono* work is to treat it the way that my firm did: make each hour of *pro bono* equivalent to an hour billed to a paying client—that's not an inexpensive decision, because that time is coming out of the partners' draws. I recall hearing, at one point, that counting *pro bono* as billable time was equivalent to a $50,000 per partner per year donation.[206]

At least *pro bono* time is an ethics requirement—or, more accurately in most places, an ethics aspiration. The time spent networking—speaking at conferences, serving on non-profit boards, and the like—isn't.[207] There's some evidence that the best way to keep a client's business is to hunker down and do a good job, rather than networking.[208] But law firms don't

206. We could then add to the basic compensation chart a new category to recognize *pro bono* work:

Billable hour work (and probably the amount collected, not just billed, to factor in the value of the work to the client)	Fixed-fee work (probably by using some calculation of the amounts budgeted for the work or by tracking the actual hours billed)	Contingency fee work	Work on behalf of the firm (committee work, mentoring)	*Pro bono* hours

207. My friend Elias George has pointed out to me that, given the difference between the weights of perceived losses and perceived gains, there needs to be twice as much recognition of a firm's *pro bono* efforts (perceived gains) to make up for the costs in lost billable time (perceived losses). In a related discussion, Dave McGowan has reminded me that the logical next step of dealing with a perceived loss would be an increased tolerance for risk to try to "break even." Much of Las Vegas's gaming world is based on this concept.

208. *See* Mark Herrmann, *Nothing You Can Say Can Cause Me to Retain You*, ABOVE THE LAW (July 15, 2013, 10:16 AM), http://abovethelaw.com/2013/07/nothing-you-can-say-can-cause-me-to-

run themselves, and there's all sorts of scutwork that people have to do to keep their firms running. Throwing people a bone by giving them a tiny amount of economic incentive to do the scutwork isn't a bad idea.[209]

F. *Changing the Willingness to Move from One Practice Group to Another.*

Some practice areas are cyclical. For example, when bankruptcy lawyers are happy, transactional lawyers usually aren't, although I'm not sure that the obverse is true. The problem is that many BigLaw lawyers work in highly specialized practice areas and can be reluctant to work in areas different from their own.[210] On the other hand, firms that are very busy in one practice area will want to reassign lawyers from less-busy practice areas, at least on a temporary basis, if they can. Logically, lawyers who are in practice areas that aren't very busy should have a vested interest in switching fields, if the alternative is getting laid off. But cognitive biases can contribute to a reluctance to switch practice areas.

Let's say that Chapter 11 work is slow. During a downturn in Chapter 11 filings, bankruptcy lawyers could hope against hope that the work will

retain-you ("Meeting me at a cocktail party and chatting me up won't work. Swapping business cards with me won't work. Following up after the cocktail party with a call or e-mail and sitting down with me for a cup of coffee or lunch won't work."). *But see* NANCY B. RAPOPORT & JEFFREY D. VAN NIEL, LAW FIRM JOB SURVIVAL MANUAL: FROM FIRST INTERVIEW TO PARTNERSHIP 151 (2014) (encouraging networking in general).

209. For example, I've heard from one lawyer at a big firm that some firms encourage their professionals to fill out nationwide surveys like the American Lawyer Mid-Level Associate Survey by offering them tokens, like Starbucks gift cards, for filling them out. Email from Lacy Lawrence to author (June 10, 2013, 7:26 PM) (on file with author). Our new chart, then, could include a column for networking and other activities with a tangential benefit to the firm:

Billable hour work (and probably the amount collected, not just billed, to factor in the value of the work to the client)	Fixed-fee work (probably by using some calculation of the amounts budgeted for the work or by tracking the actual hours billed)	Contingency fee work	Work on behalf of the firm (committee work, mentoring)	*Pro bono* hours	Networking and other work that provides less immediately tangible benefits to the firm

210. In fact, they may have such a specialized practice that retooling their skills for another type of practice would be very difficult.

pick up soon. They might be somewhat reluctant to take on matters in other practice areas because they'll want to stay "ready" when Chapter 11 work picks up again. They may "anchor" on the idea that bankruptcy work is cyclical. For example, they may interpret the publicity surrounding a few high-profile Chapter 9 cases to mean that more Chapter 11 work is just around the corner, which is perhaps an example of confirmation bias. Or they may just be afraid that their skill sets won't transfer readily to another practice area. There are rational reasons for wanting to stay ready for a resurgence of work in one's own area, where one's skills are valued.[211] But practice areas with temporary lulls are different from practice areas that are dying.[212] Our hypothetical law firm is going to have to figure out a way to hold harmless those lawyers who are willing to pitch in and work in busier practice areas than their own—either during lulls or when it's clear that their own specialties are dying—without charging clients for the necessary training involved in learning a new practice area. Maybe our hypothetical firm can develop a "team player" component of compensation to recognize how difficult it can be for a lawyer to switch practice areas, or maybe it can calculate compensation on a rolling-year cycle to take into account the ebb and flow of practice areas.

Think that a compensation formula that takes these various activities into account is a pipe dream? The Duane Morris firm designs its compensation structure to take into account attorney profitability,[213] the efficiency of those working for a particular partner,[214] each attorney's self-evaluation,[215] and a variety of other non-billable work.[216] If a firm wants

211. For a great book discussing how to encourage people to consider change when they've developed rational reasons to resist change, see ROBERT KEGAN & LISA LASKOW LAHEY, IMMUNITY TO CHANGE: HOW TO OVERCOME IT AND UNLOCK THE POTENTIAL IN YOURSELF AND YOUR ORGANIZATION (2009). Another one of their books, ROBERT KEGAN & LISA LASKOW LAHEY, HOW THE WAY WE TALK CAN CHANGE THE WAY WE WORK: SEVEN LANGUAGES FOR TRANSFORMATION (2002), provides an excellent method for uncovering the gap between what people intend to do and what they actually accomplish.

212. One doesn't see a lot of slide-rule and buggy-whip factories these days.

213. *See* Heidi K. Gardner & Annelena Lobb, *Collaborating for Growth: Duane Morris in a Turbulent Legal Sector*, HARVARD BUSINESS SCHOOL CASE STUDY 9-414-022 at 8–9 (July 26, 2013) (describing Duane Morris's "matter contribution analysis (MCA) system" as a "a quantitative system used to calculate profitability by . . . individual attorneys" that "became the basis of the firm's quantitative analysis for compensation").

214. *See id.* at 10 ("[P]artners were evaluated on the efficiency of their overall 'team,' defined as including anyone who received 25% or more of their work from the focal partner. 'We get credit for working regardless of whether I'm working on my matter or your matter or someone else's matter; I'm still working,' noted [one Duane Morris attorney].").

215. *See id.* (describing what an attorney was expected to include in the required yearly self-

to change its professionals' behavior, it has to take pains to reward the behavior that it wants. If it calibrates those reward systems accurately—likely after much trial and error—it should start to see positive results.

V. CAVEATS AND CONCLUSION

> *[N]o individual, no government, is ever going to be as smart as the people who are scheming against you. So when you introduce an incentive scheme, you have to just admit to yourself that no matter how clever you think you are, there's a pretty good chance that someone far more clever than yourself will figure out a way to beat the incentive scheme. So, one response is to say, well, before I put it in place, let me at least try to think through all the crazy different approaches that might be taken that could trick my incentive scheme. But even on top of that, I think you want to design incentive schemes that are relatively simple. The more complicated you make something, the more opportunities there are for people to game it. If it's simple, you usually think if you're reasonably intelligent, you can think about a lot of the ways that people might respond to it, and prevent these sort of unexpected, backfiring, overly zealous responses to what you're doing.*[217]

We don't have any data (yet) indicating that any of my suggestions will work. We might be able to gather some data over time. For example, law firms might track the realization rate of their fees to see if any of the nudges that encourage more timely billing practices have resulted in fewer fees being written off. Firms might be able to compare the retention rate of associates with more active mentors versus the retention rate of associates whose mentors are less hands-on. It's possible, perhaps, to study whether lawyers whose non-billable-hour efforts are valued tend to stay at law firms. Of course, we'll never be able to overcome the "correlation isn't

evaluation memo).

216. *See id*. ("Sharon Caffrey, a Duane Morris partner based in Philadelphia, noted many factors in her own compensation: 'I run the products liability group, I'm very active in the firm's women's initiative. I'm on the partners' board. I do a lot of unbillable things for the firm, but I feel I get compensated for them to some extent.'").

217. Interview by Stephen J. Dubner with Steven D. Levitt, *The Cobra Effect—A New Freakonomics Radio Podcast*, FREAKONOMICS RADIO (Oct. 11, 2012, 11:28 AM), http://freakonomics.com/2012/10/11/the-cobra-effect-a-new-freakonomics-radio-podcast. As my dad has reminded me on several occasions, "nothing is foolproof because fools are so ingenious." *Murphy's Laws Site*, http://www.murphys-laws.com/murphy/murphy-laws.html (last visited February 26, 2014); *see Talk: Murphy's Law*, WIKIQUOTE (Aug. 26, 2010, 3:15 PM), http://en.wikiquote.org/wiki/Talk:Murphy%27s_law (attributing this saying to the "Murphy" of Murphy's Law).

causation" problem,[218] and many factors might contribute to a client paying more of a given bill or a lawyer deciding to stay longer at a firm. Firms should come up with some markers of success,[219] of course, so that they can try to measure if their changed incentives are getting the right behavior.

And firms should come up with some ways to encourage subtle changes in certain types of behavior if they want to adapt to the increased pressure that major clients are exerting. On the other hand, there are many reasons why law firms won't leap to take advantage of my suggestions.[220] Let's look at some barriers to change.[221]

One barrier to change is that I might be flat-out wrong as to how any of my proposed changes will work.[222] Another barrier involves relative leverage: the larger or more powerful the practice group in the firm, the more difficult it might be to change that group's collective behavior[223]—there will be many more people exerting lots of social pressure *not* to change, and many of those people will suggest that the changes "should apply to thee and not to me." They'll rationalize (perhaps accurately) that fixing problems in a litigation department will differ from fixing problems in a transactional department—in other words, that not all solutions should be firm-wide. Moreover, they may attribute past ethics missteps to the moral failings of some of the individuals within the firm, rather than to

218. I doubt that we'll see any "control group" lawyers.

219. Hat tip to my buddies Mary Beth Beazley and Art Greenbaum for pointing this out to me.

220. Not the least of which is that I haven't worked at a law firm in decades. (I've been around a lot of lawyers, both as a law professor and as an expert witness, though.)

221. Richard Thaler and Cass Sunstein have noted:

> A group will shift if it can be shown that the practice is causing serious problems. But if there is uncertainty on that question, people might as well continue doing what they have always done. An important problem here is "pluralistic ignorance" – that is, ignorance, on the part of all or most, about what other people think. We may follow a practice or a tradition not because we like it, or even think it defensible, but merely because we think that most other people like it. Many social practices persist for this reason, and a small shock, or nudge, can dislodge them.

RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 58–59 (2009).

222. When it comes to proposing what types of changes will work in a particular law firm, the fact that I'm around lawyers a lot may not be a perfect substitute for hearing from lawyers who work in that firm.

223. *Cf.* STEVEN D. LEVITT & STEPHEN J. DUBNER, FREAKONOMICS: A ROGUE ECONOMIST EXPLORES THE HIDDEN SIDE OF EVERYTHING 45 (2d ed. 2006) ("[A] smaller community tends to exert greater social incentives against crime, the main one being shame.").

the incentive structure and default rules within the firm.[224] As Jennifer Robbennolt and Jean Sternlight have pointed out:

> Consistent with the *actor-observer bias,* we attribute others' moral failings to flaws in their dispositions, but attribute our own missteps to situational factors. We focus more on ethics when judging others, but find competence more important than integrity when judging ourselves. And we judge others based on faulty predictions about what we might have done under the same circumstances.[225]

Changing various default rules (not to mention installing the computer programs associated with billing that I want to develop) will create a lot of resentment, and very clever people[226] will develop some work-arounds that may entirely defeat the changes.[227] It's possible, in fact, that every

---

224. Not that there aren't bad people. There are. But I think that more people behave badly due to the situations in which they're placed rather than due to some innate psychopathy.

225. Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1150 (2013) 36–37 (footnotes omitted). They go on to point out:

> But while we can be relatively harsh judges of others' ethics, our psychology can make it difficult to notice and respond to others' unethical behavior. First, limits on our ability to pay attention can lead us to miss unethical behavior right in front of us when we are focused on other things like our own cases and deadlines. Second, we have a tendency to identify with other people—colleagues or clients—whose interests are aligned with ours, making it harder to notice and objectively assess their ethics. Similarly, it can be difficult to acknowledge the unethical behavior of others when doing so would harm one's own interests. This *motivated blindness* can cause our judgments to be biased in favor of our client or colleague and we are inclined to view their actions favorably, disinclined to believe that they have acted wrongly, and able to recruit reasons to support their actions. Third, we may let others off the hook because we are aware of other instances in which they have acted ethically—a form of *moral licensing*. Fourth, just as it can be difficult to identify the point at which one's own behavior has gradually crossed the line, detection of when others' incrementally degrading behavior becomes unethical can be challenging. Fifth, the fact that *outcome bias* may cause our evaluations of the quality of a decision to be influenced by how the decision turns out, can lead us to ignore others' unethical decisions unless and until something bad happens.

Id. at 1150-51 (footnotes omitted).

226. Including the very clever people who work in law firms.

227. My colleague Jean Sternlight reminded me of the classic "unintended consequences" story: the "rat tail" incident.

> Appealing to both civic duty and to the pocketbook, a one-cent bounty was paid for each rat tail brought to the authorities (it was decided that the handing in of an entire rat corpse would create too much of a burden for the already taxed municipal health authorities). Unfortunately, this scheme backfired. Despite initial apparent success, the authorities soon discovered that the best laid plans of mice and men often go awry. As soon as the municipal administrators

law firm might want to change but is waiting for its major competitors to make the first move, in much the same way that many law schools are waiting for their major competitors to try out new curricula and two-year J.D. programs first.

Let's return to the point that I made at the very beginning of this article: incentives at work, even those that the employer hasn't created consciously, will inexorably trigger certain behavior from employees. If a law firm wants to change that behavior, then it needs to spend some significant time figuring out which of its many incentives triggered that behavior. It's not enough to say, for example, that late-submitted timesheets are bad and that we therefore have to force people to turn their timesheets in promptly. We have to ask ourselves what in the firm's incentive structure induces some people to turn their timesheets in late. Is it that their workload is so high and so frenetic that they don't believe that they have sufficient time to record their activities contemporaneously? Is it that the firm puts such a premium on high-billing attorneys that it cuts them too much slack on their non-billable duties?[228] Is it that dicing time into tenths of an hour makes describing those tasks that take under thirty minutes to do just not worth the effort of recording them? Once we figure out what's driving certain behavior, then we can start thinking about developing ways to alter the incentive structure. We will come up with

> publicized the reward program, Vietnamese residents began to bring in thousands of tails. While many desk-bound administrators delighted in the numbers of apparently eliminated rats, more alert officials in the field began to notice a disturbing development. There were frequent sightings of rats without tails going about their business in the city streets. After some perplexity, the authorities realized that less-than-honest but quite resourceful characters were catching rats, but merely cutting off the tails and letting the still-living pests go free (perhaps to breed and produce more valuable tails). Later, things became even more serious as health inspectors discovered a disturbing development in the suburbs of Hanoi. These officials found that more enterprising but equally deceptive individuals were actually raising rats to collect the bounty. One can only imagine the frustration of the municipal authorities, who realized that their best efforts at *dératisation* had actually increased the rodent population by indirectly encouraging rat-farming.

Michael C. Vann, *Of Rats, Rice, and Race: The Great Hanoi Rat Massacre, an Episode in French Colonial History*, 4 FRENCH COLONIAL HIST. 191, 198 (2003).

228. For a good case study of this particular phenomenon—letting high-billing attorneys violate other firm procedures—see MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER 52–54 (Univ. of Michigan Press 2004). As Professor Regan explained, "[i]n 1994, [John] Gellene's billable hours approached 3,000 . . . . [His] tendency toward intense tunnel vision sometimes led him to ignore the administrative requirements that accompany life in a large law firm . . . . Most glaringly, his chronic failure to submit his 'daynotes,' or billing records, on time was a source of frustration." *Id.*

new incentives that will still have some bad, or maybe outright awful, unintended consequences. But we have to try.[229] We know enough about human behavior and enough about the sea changes in legal practice that it's time to try. As the book *Freakonomics* points out so well:

> Incentives are the cornerstone of modern life. *And understanding them—or, often, ferreting them out—is the key to solving just about any riddle, from violent crime to sports cheating to online dating.*[230]

229. As Lyle Lovett sings: "But what would you be if you didn't even try? You have to try[.]" *Here I Am Lyrics*, METROLYRICS, http://www.metrolyrics.com/here-i-am-lyrics-lyle-lovett.html (last visited Jan. 24, 2014).

230. STEVEN D. LEVITT & STEPHEN J. DUBNER, FREAKONOMICS: A ROGUE ECONOMIST EXPLORES THE HIDDEN SIDE OF EVERYTHING 11 (1st ed. 2005).

VIRTUOUS BILLING

Randy D. Gordon* & Nancy B. Rapoport**

Aristotle tells us, in his Nicomachean Ethics*, that we become ethical by building good habits and we become unethical by building bad habits: "excellence of character results from habit, whence it has acquired its name (*êthikê*) by a slight modification of the word* ethos *(habit)." Excellence of character comes from following the right habits.*

*Thinking of ethics as habit-forming may sound unusual to the modern mind, but not to Aristotle or the medieval thinkers who grew up in his long shadow. "Habit" in Greek is "*ethos*," from which we get our modern word, "ethical." In Latin, habits are moralis, which gives us the word, "moral." Aristotle explains that we cannot alter nature by practice: we cannot teach or train a rock to roll up a hill no matter how often we throw it up. But we can alter ourselves by practice. We can train ourselves to be ethical by practice, just as we learn to play the harp by practice.*[1]

It is a timeless adage that when analyzing the unacceptable behavior of others, one should never attribute to malice that which can be adequately explained by stupidity.[2]

---

* Partner and Chair, Antitrust and Trade Regulation Practice of Gardere Wynne Sewell LLP; Adjunct in Law and English, Southern Methodist University. Many thanks to Hon. Ed Kinkeade, Bill Bridge, and Larry Allums for helpful comments on an earlier version of my contributions to this paper.

** Garman Turner Gordon Professor of Law, William S. Boyd School of Law, UNLV. Many thanks to research assistants Jesse Hogin and Delaney Berman, and to Jack Ayer, Peter Bayer, Ralph Brubaker, Bernie Burk, Tigran Eldred, Susan Saab Fortney, Randy Gordon, Jennifer Gross, Dan Hamilton, Nettie Mann, Morris Rapoport, Jean Sternlight, and Jeff Van Niel, all of whom make me look much smarter thanks to their help.

[1] Ronald D. Rotunda, *Why Lawyers Are Different and Why We Are the Same: Creating Structural Incentives in Large Law Firms to Promote Ethical Behavior—In-House Ethics Counsel, Bill Padding, and In-House Ethics Training*, 44 AKRON L. REV. 679, 711–12 (2011) (footnote omitted).

[2] Douglas R. Richmond, *For a Few Dollars More: The Perplexing Problem of Unethical Billing Practices by Lawyers*, 60 S.C. L. REV. 63, 82 (2008).

TABLE OF CONTENTS

INTRODUCTION

During the Conference on Psychology and Lawyering that Professor Jean Sternlight hosted at the William S. Boyd School of Law,[3] the two of us spoke about the psychology of legal ethics. Drawing on the humanities background that one of us has[4] and the social science background of the other,[5] we dis-

[3] *Conference on Psychology and Lawyering: Coalescing the Field*, UNLV WILLIAM S. BOYD SCHOOL OF LAW, http://www.law.unlv.edu/PsychologyLawyering2014 (last visited Feb. 22, 2015).

[4] *Randy D. Gordon*, GARDERE, http://www.gardere.com/Professionals/Randy-D-Gordon/ (last visited June 10, 2015).

[5] *Nancy B. Rapoport*, UNLV WILLIAM S. BOYD SCHOOL OF LAW, http://www.law.unlv.edu/faculty/nancy-rapoport.html (last visited Feb. 22, 2015); *see also* Curriculum Vitae, Nancy B. Rapoport, *available at* http://www.law.unlv.edu/sites/default/files/faculty/resumes/rapoport_cv_5_15_15.pdf.

cussed the importance of understanding the incentives that encourage lawyers to behave in certain ways.[6] We still believe that the incentives that organizations develop—intentionally (through policies and procedures) or inadvertently (through the unintended consequences of those policies and procedures)—have profound effects on behavior, but we also believe that an understanding of how to use the classical concept of "virtue"[7]—as the development of habits that shape character—can help people interact with those incentives. In particular, we want to explore the concept of "virtue" as it relates to billable behavior: How should lawyers bill clients? Is it possible for lawyers to develop some billing habits that will make it easier for them to bill more ethically? And should law firms care?[8]

I. "VIRTUE" IN THE LEGAL PROFESSION AND THE CULTURE(S) OF LAW FIRMS

Most everyone would agree, we think, that there are things about the practice of law that make it meaningfully different from other occupations and that there are things about law firms that—at least traditionally—make them meaningfully different from other organizational forms. These differences manifest in two ways that are important to our discussion. First, the practice of law both ethically and with skill requires lawyers to develop and maintain law-specific habits of mind. Second, law firms mature into unique cultures that—depending on the shape and substance of that culture—either impede or promote the virtues congenial to those salutary law-specific habits of mind.

A. The "Two Cultures" of Legal Education and Law Practice

Over fifty years ago, C.P. Snow examined—and decried—the rise of what he called the "two cultures."[9] Snow used this metaphor to capture what he saw as an inability to communicate between[10] communities of scientists and communities of literary intellectuals. His two-culture metaphor seems basically right to us,[11] and we think that it may be useful to frame our discussion of virtue with the notion of "culture" in the Snowian[12] sense of how groups of similar

---

[6] For a longer discussion of incentives and lawyer behavior, see, e.g., Nancy B. Rapoport, *"Nudging" Better Lawyer Behavior: Using Default Rules and Incentives to Change Behavior in Law Firms*, 4 ST. MARY'S J. LEGAL MALPRACTICE & ETHICS 42 (2014).

[7] At least one of us believes that it is less important that a person be ethical than it is that she behave as if she were ethical. *See infra* note 161.

[8] We think that law firms *do* care. For one thing, more and more of them are analyzing their bills to mine useful data about billing patterns. *See, e.g.*, Aric Press, *What the Rise of Pricing Officers Says About Big Law's Future*, AM. LAW. (July 3, 2014), http://www.americanlawyer.com/id=1202661735831.

[9] C.P. SNOW, THE TWO CULTURES vii–viii (1998).

[10] To comprehend across, really.

[11] Though subject to qualification and criticism (much of which he himself anticipated and conceded).

[12] If "Snowian" isn't a word, it should be. And Paul Horwitz has suggested, in a Facebook post, that academics should consider using "-ish" instead of "-ian." We're cool with the non-

people almost instinctively respond alike to a problem, situation, or subject. By way of preview, we'll posit that two "cultural" obstacles stand in the way of "virtue" in the legal profession: first, separate cultures have grown up around legal education and legal practice; and second, legal practice itself has migrated from one culture (professionalism) to another (commerce). Each of these divergences is antithetical to the notion of virtue, for two reasons: first, because the legal education/legal practice divide has engendered mutual suspicion between enterprises that should operate in tandem, and second, because the profession/commerce migration has forced an attendant focus from the internal goods of legal practice (being a skilled lawyer) to the external goods of legal practice (making money and enhancing one's prestige). But before moving to specifics, we need to pause and consider what virtues *should* obtain in the context of law, and that means that we're about to get a little bit hoity-toity about the concept of virtue.

B. "Virtue" in the Classical Sense

In heroic societies (think of the *Iliad*[13] or *Beowulf*[14]), virtues and people's roles were inseparable, and the concept of virtue coincided with the notion of excellence (e.g., a great runner displays excellence of the feet).[15] Not surprisingly, given the tribal and war-like nature of heroic societies, courage was considered to be a high virtue—one tangled up with notions of loyalty, kinship, and success. By the time of Aristotle, the concept of one's "role" in a culture gave way to the importance of the *polis* (i.e., the city-state form of social structure), the vestiges of which still exist in institutions dedicated to the common good (e.g., hospitals, philanthropic organizations, and we would submit, once upon a time, law firms).[16] Accordingly, values like judgment, friendship,[17] and justice emerged as important institutional virtues.[18] It's not surprising then, that we still find these virtues itemized in general discussions of virtues in all the professions. But law—if not quite an autonomous discipline—also has a particular *telos*,[19] and we must accordingly attend to law's own goals if we are to identify virtues that facilitate their attainment.

---

word "Snowish," but we'll stick with the non-word "Snowian" for this article. Paul Horwitz, FACEBOOK, https://www.facebook.com/paul.horwitz.3 (last visited Feb. 7, 2015).

[13] HOMER, THE ILIAD (Robert Fagles trans., 1991).

[14] BEOWULF: A NEW VERSE TRANSLATION (Seamus Heaney trans., 2000).

[15] ALASDAIR MACINTYRE, AFTER VIRTUE: A STUDY IN MORAL THEORY 122 (2d ed. 1984).

[16] *See id.* at 155.

[17] *Id.* at 156. Defined back then as a shared recognition and pursuit of a good. *Id.*

[18] *Id.* at 155–56. We could, of course, look elsewhere for a catalogue of virtues, ranging from Ben Franklin's utility-derived aphorisms to Jane Austen's emphasis on amiability and constancy. *Id.* at 181–87, 239–43. But the *Law Journal's* editors gave us a page limit, and we promised to stick to it.

[19] A "telos" is an "end"—i.e., a purpose or goal. THE DICTIONARY OF PHILOSOPHY 557 (Dagobert D. Runes ed., 2001); *cf.* MACINTYRE, *supra* note 15, at 184–85.

C. "Practice" as a Synonym of Sorts of "Profession"

To help us sort out what virtues should obtain in the practice of law, we think it's helpful to consider the concept of a "practice" that Alasdair MacIntyre develops in his book *After Virtue*.[20] There, MacIntyre proposes this mouthful:

> [A practice is] any coherent and complex form of socially established cooperative human activity through which goods internal to that form of activity are realized in the course of trying to achieve those standards of excellence which are appropriate to, and partially definitive of, that form of activity, with the result that human powers to achieve excellence, and human conceptions of the ends and goods involved, are systematically extended.[21]

Once an activity becomes "institutionalized" (in Neil MacCormick's sense of the word),[22] it qualifies as a "practice" (in MacIntyre's sense of that word).[23] Here are a few of the contrasting examples that MacIntyre suggests should sharpen the understanding of a "practice": tic-tac-toe is not a practice, chess is; throwing a ball—even with skill—is not a practice, football is; bricklaying is not a practice, architecture is.[24] By these lights, we think that we can safely categorize "lawyer-work" as a practice.[25]

What, then, are the virtues associated with practices? To get us started down this path, MacIntyre suggests a tentative definition of a virtue: "A virtue is an acquired human quality the possession and exercise of which tends to enable us to achieve those goods which are internal to practices and the lack of which effectively prevents us from achieving any such goods."[26] He goes on to name "justice, courage and truthfulness" as common virtues.[27] Not surprisingly, these virtues show up in most discussions of legal virtue, with "justice" occupying the place of preeminence and rising to the level of the *telos* for the whole enterprise.[28] To this list, legal commentators often add things like prudence, compassion, and wisdom.[29]

---

[20] MACINTYRE, *supra* note 15, at 187.

[21] *Id.* Yes, we too had to read that quote over about thirty times to understand it.

[22] NEIL MACCORMICK, INSTITUTIONS OF LAW: AN ESSAY IN LEGAL THEORY 21 (2007).

[23] MACINTYRE, *supra* note 15, at 187.

[24] If you were thinking of *Jacobellis v. Ohio* while reading this sentence, we wouldn't blame you. *See* Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (stating that he knows pornography "when [he] see[s] it").

[25] Judge Posner makes a similar point in identifying law as a "profession" in a way that business is not. For him, the distinguishing mark of a profession is its requirement that a person "master[] a body of formal knowledge." Richard A. Posner, *The Material Basis of Jurisprudence*, 69 IND. L. J. 1, 5 (1993). He further compartmentalizes law as a *restricted* profession in that entry into it requires satisfaction of numerous prerequisites (education, licensing, etc.). *Id.* at 6.

[26] MACINTYRE, *supra* note 15, at 191.

[27] *Id.* at 194.

[28] One of us can't resist this quote from Deuteronomy 16:18–21:9:

> Judges and officers shall you appoint in all your gates, which the Lord your G[-]d gives you, throughout your tribes; and they shall judge the people with just judgment. You shall not

D. The Cultures of Legal Education and Legal Practice

With this backcloth stitched into place, we want to return to the twin cultural obstacles to identifying virtue in law: the divide between legal education and law practice, on the one hand, and within legal practice, on the other. Judge Richard Posner has suggested that the legal system in the United States has developed along the lines of a cartel.[30] That cartel formed, in large part, first because of changes in the training of lawyers[31] and then because of resulting changes in the licensing of lawyers.

1. The Development of Formal Legal Education

Throughout the Nineteenth Century, educational standards rose, and by the time that the Twentieth Century was starting to appear on the horizon, a movement to make the practice of law[32] a restricted occupation started to develop. Posner and others date the beginnings of this movement to 1870, when Christopher Columbus Langdell—the then-dean of Harvard Law School—revolutionized legal education.[33] Langdell believed that law was a science and that opinions written by appellate judges were the raw materials of this branch of science.[34] So, in Langdell's view, just as geologists study rocks and zoologists study animals, lawyers should study published case opinions through a lengthy curriculum. As Posner somewhat wryly observes,[35] this curriculum became mandatory for those wanting to enter the profession.[36] And for the new system to jell completely, it required the abolition of the centuries-old practice

---

> pervert judgment; you shall not respect persons, nor take a bribe; for a bribe blinds the eyes of the wise, and perverts the words of the righteous. Justice, justice shall you pursue, that you may live, and inherit the land which the Lord your G[-]d gives you.

1 SOLOMON SIMON & MORRISON DAVID BIAL, THE RABBI'S BIBLE, TORAH 201 (1966). This whole idea of justice as law's goal goes back a long way.

[29] Prudence, compassion, and wisdom, by the way, happen to overlap in good part with the list of physician virtues that people like Jennifer Radden and John Sadler have proposed in another professional context. *See* JENNIFER RADDEN AND JOHN Z. SADLER, THE VIRTUOUS PSYCHIATRIST: CHARACTER ETHICS IN PSYCHIATRIC PRACTICE 14 (2010). And just as an aside, we think that this substantial overlap between physician and lawyer virtues gives at least slight evidential weight to the credibility of MacIntyre's posited link between virtues and practices.

[30] Posner, *supra* note 25, at 1–2.

[31] For a discussion of the development of one early law school, along with a bit of shameless self-promotion on the part of one of us, see Nancy B. Rapoport, *Plus Ça Change, Plus C'est La Même Chose*, 17 GREEN BAG 2D 55, 56–57 (2013).

[32] And, coincidentally, medicine. *See, e.g.*, *supra* note 29.

[33] *See* Posner, *supra* note 25, at 15. We wouldn't blame current law students for resenting Langdell.

[34] *Id.*

[35] He's good at that sort of thing.

[36] Posner, *supra* note 25, at 15. One can contrast, then, the study of law with that of the sciences—one doesn't have to have a degree in a particular scientific discipline in order to "do" science or to invent something.

of prospective lawyers entering the profession through a process of apprenticeship combined with self-study ("reading the law").

It took some time for the Langdellian law school system to attain a monopoly over lawyer training.[37] But, as Posner notes, "by 1960, four years of college . . . plus three years at an accredited law school," plus things like bar examinations and good character requirements, "formed a series of hoops through which almost everyone who wanted to become a licensed practitioner of law in this country had to jump."[38] At the same time, state prohibitions against the unauthorized practice of law put teeth into these new educational requirements and thereby created what antitrust lawyers call a "bottleneck" at the law school level. So what are the consequences of the near-complete ascendancy of the Langdellian system?

That system has created a number of economic incentives for universities, because consumers (prospective lawyers) have to buy the product at cartel prices, and the product is relatively cheap to deliver (large lecture classes capped by a single examination at the end of the semester). Simply put, law schools can be relatively profitable[39] (compared to typical humanities departments, with low student-to-faculty ratios and relatively lower tuition), and they can be started with a relatively low capital investment (compared to medical or engineering schools, which need labs). Second, as Philip Kissam has argued,[40] the Langdellian[41] system propagates itself across every aspect of law schools in a manner that he likens to a Foucaultian[42] discipline, by which he means a "subterranean and habitual system of routine practices and tacit lessons" that serve to resist change and blunt any institutional development.[43] The chain of Kissam's argument is too long to follow here,[44] but one of its segments is worth pausing to consider, especially since it pretty much squares with two of the most discussed recent critiques of legal education,[45] *Educating Lawyers* (popu-

---

[37] *Id.* at 15 ("As late as 1951, twenty percent of American lawyers had not graduated from law school, and fifty percent had not graduated from college."); *see also* Rapoport, *supra* note 31, at 55 (describing the history of New York University's first law school).

[38] Posner, *supra* note 25, at 15.

[39] Although one of us wants to point out that, at least for state law schools, that profitability can be destroyed by the way that the state decides to fund legal education.

[40] PHILIP C. KISSAM, THE DISCIPLINE OF LAW SCHOOLS: THE MAKING OF MODERN LAWYERS 7 (2003).

[41] *Cf. supra* note 12; *see also* Aside, *The Common Law Origins of the Infield Fly Rule*, 123 U. PA. L. REV. 1474, 1474 nn. 1 & 4 (1975).

[42] Want to know about Michel Foucault? *See Michel Foucault*, STANFORD ENCYCLOPEDIA OF PHILOSOPHY (May 22, 2013), http://plato.stanford.edu/entries/foucault/.

[43] KISSAM, *supra* note 40, at 4.

[44] Trust us.

[45] Brian Tamanaha's book, *Failing Law Schools*, is a third. BRIAN Z. TAMANAHA, FAILING LAW SCHOOLS (2012). For a partial list of reviews of that book, see Paul Caron, *More Reviews of Tamanaha's Failing Law Schools*, TAXPROF BLOG (Feb. 13, 2014), http://taxprof.typepad.com/taxprof_blog/2014/02/more-reviews.html.

larly known as the *Carnegie Report*)[46] and Roy Stuckey's *Best Practices*.[47] Kissam, Stuckey, and the authors of the *Carnegie Report* all make the same point when they contend that the Langdellian system doesn't produce "practice-ready" graduates of the sort that come out of trade schools, or even out of university-level programs in education, pharmacy, or medicine.

Of course, until fairly recently, most law firms didn't complain all that much about the lack of practical training in their new hires. The recent change of heart is one worth exploring because we'll find that it's emblematic of the other cultural change that we want to emphasize: the migration of law practice from a professional culture to a commercial culture. There's a straight line from the liminal moment between law practice as a profession and law practice as commerce directly to the billing issue that is our principal focus in this article.

2. *Law Practice and the Changes in Training New Lawyers After Graduation*

That straight line is intersected by a change in how new lawyers actually learn how to practice. There never was, of course, a "golden age" of law practice in which lawyers toiled harmoniously in the Garden of Justice.[48] But it's fair to say that law practice has become less professionally focused and more commercially focused over the past few decades.[49] As a consequence, yet another impediment has been placed in the lawyer's road to virtue. And all this bottom-line commercialism has exacerbated the legal education/law practice divide, because practicing lawyers have diminished the important role that they once played in both legal scholarship and new lawyer training.[50]

If a lawyer from 1950 were parachuted into the present, we suspect that the most startling change that he[51] would notice in the legal landscape would be the overall number of lawyers and the size (both in terms of number of lawyers and geographic scope) of law firms. Two statistical examples can illustrate this point: in 1951, there were about 220,000 lawyers; in 2000, this number was well over a million. In the late 1950s, fewer than forty firms in the U.S. had fifty lawyers or more; now there are around two dozen that number close to or

---

[46] WILLIAM M. SULLIVAN ET AL., EDUCATING LAWYERS: PREPARATION FOR THE PROFESSION OF LAW (2007).

[47] ROY STUCKEY ET AL., BEST PRACTICES FOR LEGAL EDUCATION (2007).

[48] *Cf. Iron Butterfly—In A Gadda Da Vida*, YOUTUBE (June 19, 2008), https://www.youtube.com/watch?v=2bQZ6l_cq5Y.

[49] *See, e.g.*, Bernard A. Burk & David McGowan, *Big but Brittle: Economic Perspectives on the Future of the Law Firm in the New Economy*, 2011 COLUM. BUS. L. REV. 1, 92; Rapoport, *supra* note 6.

[50] Hence, the present attempt to push more experiential and practical training back into the law schools.

[51] And it would almost inevitably have been a "he" back then.

over one thousand lawyers.[52] Lots of factors caused that explosion in the number of lawyers, but our point is that the explosion is a real phenomenon.[53] Until relatively recently, when various pressures caused law firms to rethink their business models, there was a lot of money to be made in law by those who could grab it. And one way to "grab it" was to create very large, highly leveraged firms (i.e., lots of associates and few equity partners) that could siphon off "premium" work at premium rates.[54]

With the rise of large, highly leveraged law firms came the transition from profession to business—and with that transition came the transition to metrics that created disincentives for lawyers to spend any non-billable time training new lawyers.[55] Reward systems reflect a firm's values far more accurately than do "mission statements," "value statements," and letterhead slogans. When the reward systems involve only factors that relate to billable time, then value-maximizing lawyers will focus on billable time to the exclusion of any other things that might inure to their firm's benefit.[56]

Most firms keep two types of statistics from which nearly all promotion and compensation decisions are made: "originations," which tracks who brought the work into the firm, and *paid* billable hours.[57] Consequently, as William Henderson observes, none of this statistical myopia is lost on law firm partners, who often valorize these metrics, rank them well above other values, and slip into the short-term thinking that those metrics represent:

---

[52] Jake Simpson, *Law360 Reveals 400 Largest US Law Firms*, LAW360 (Mar. 23, 2014, 9:45 PM), http://www.law360.com/articles/518950/law360-reveals-400-largest-us-law-firms.

[53] Why the explosion in the number of lawyers? There are many reasons, among them the breakdown of the cartel that had restricted membership by race, class, and gender, the growing propensity of corporations to move work from firm to firm (or to parcel work out to different firms), a surge in government regulations, and an explosion in litigation fueled in part by relaxed class-action rules, a judicial receptiveness to punitive damages awards, and a willingness by courts to wander into areas that had once been marked off as "political."

[54] This leverage came at a cost in terms of the older "partnership" model in which the partners actually knew one another, socialized together, and made decisions as a group. One of the now-retired members of Randy's firm used to talk about how all the lawyers at Gardere, Porter & DeHay (an earlier incarnation of his firm) would sit around a table on Saturday morning and open the mail together. Now, large firms are impersonal—they're bureaucracies, really—and, according to Abe Krash, a retired Arnold & Porter partner,

> Decisions . . . that were once influenced in significant part by tradition, loyalty, and regard for past contributions to the firm are determined by bottom-line, objective factors. The lock-step system of compensation has been replaced by an "eat-what-you-kill" system geared toward business generation. The relations among partners, and between partners and associates, are shaped to a great extent by considerations of profitability.

Abe Krash, *The Changing Legal Profession*, WASH. LAW., Jan. 2008, at 30, 33.

[55] For a discussion of how incentives can change law firm behavior, see Rapoport, *supra* note 6.

[56] *See id.*

[57] Clients may not pay all of their bills and may negotiate with their lawyers to reduce their bills, *see, e.g.*, *id.* at 46–48, so "paid" time matters more than mere "billed" time.

> This incentive problem, which focuses a lawyer's attention on the current fiscal year, is evident in a 2012 survey of over 2200 partners at major law firms. . . .
>
> When asked to assess the importance of various factors that are considered in determining compensation at their firms, origination of business was ranked as the most important factor (74 [percent] picking "very important") followed by revenues generated through that partner's work for clients (59 [percent]). In contrast, management responsibilities was selected as "very important" by only 9 [percent] of respondents; and only 10 [percent] of respondents reported that good citizenship was very important. When asked what was "most important" in determining compensation, 65 [percent] selected origination followed by 21 [percent] for working attorney receipts.[58]

To make matters worse, these seemingly "objective" metrics mask an underlying set of contingencies, ranging from how the business was generated (for example, is it "new" or from a hundred-year client?) to why the client didn't pay for the hours billed (was the work shoddy, or was the client a deadbeat?). The supposed objectivity of the statistics is further undermined because they at once show too much and too little.[59] For instance, suppose Partner X is credited with $1,000,000 in business originations. But what if he's a terrible lawyer? What if the business came in through a cold call to the switchboard? What if he runs off every potential rival in his practice area, each of whom goes on to be a very successful lawyer at another firm? Or what if he actually turns off five potential clients for every one that he lands?

So why do firms use such metrics when they so clearly serve to enhance only the external goods of the practice (i.e., money and its collateral prestige)? The short answer is lawyer mobility. At one point, most firms were organized under the Cravath model,[60] in which firms hired the "best and brightest" from law school, eventually made some of those hires into partners for life, and exported the rest to positions with clients, the government, or firms in regional markets. There were virtually no lateral moves at the partnership level, a situation facilitated by stable client relationships. But as client loyalty waned, a market developed for lawyers with portable business. Thus, although many partners would, as Galanter and Henderson have put it,

> gladly trade a portion of their earnings for a shorter workweek, greater job security, more interesting work, the opportunity to mentor (or be mentored), do more pro bono work, or take a long, uninterrupted vacation . . . , these aspirations are

---

[58] William D. Henderson, *From Big Law to Lean Law*, 38 INT'L REV. L. & ECON. 5, 10–11 (2013) (footnotes omitted).

[59] For you baseball nuts out there, think about how Randy's fellow Kansans Bill James and Michael Lewis have shown that the statistical conventional wisdom can be counterproductive—even wrong. *See, e.g.*, MICHAEL LEWIS, MONEYBALL: THE ART OF WINNING AN UNFAIR GAME (2003).

[60] Named after the elite New York firm Cravath, Swain & Moore. *See, e.g.*, William D. Henderson, *Three Generations of U.S. Lawyers: Generalists, Specialists, Project Managers*, 70 MD. L. REV. 373, 376–77 (2011); Eli Wald, *The Rise and Fall of the WASP and Jewish Law Firms*, 60 STAN. L. REV. 1803, 1807–08 (2008).

> virtually impossible to negotiate when rainmaking partners located in multiple offices through the world are free to exit at any time with clients in tow.[61]

In effect, then, the internal goods of the practice (being an excellent lawyer who serves clients well) are held hostage to the external (money and prestige).[62]

What the devolution from the internal to the external means is that Aristotelian "friendship" (i.e., the virtue that holds institutions together) is no longer possible in law firms.[63] Indeed, the friendship bond has been replaced by a pervasive sense of anxiety: competitors are always poaching key clients; younger lawyers aren't developing strong loyalties because they see their future riddled with contingencies; management is focusing on deceptive metrics; and even highly successful partners can see their careers hit the rocks after a major client defects to another firm.[64] Above all, as one commentator tartly puts it, "[l]arge firms view good lawyers as expendable."[65] As a consequence:

> For the vast majority of modern large law firms, economics rather than culture are the glue that holds the firm together. Indeed, the distinguishing feature of the elastic tournament is a constant focus on the real or imagined marginal product of each lawyer in the firm—associates, of counsel, sundry off-track attorneys, and equity and non-equity partners. Although this system is remarkably effective at maximizing the financial return on (at least some) human capital, it simultaneously undermines or hinders other values cherished by the profession.[66]

That economic conundrum leads us back into the legal education issue with which we started—and will lead us further into the billing thickets that have entangled the profession. In the past, new lawyers learned to apply their legal education through a combination of watching and doing. Several forces have

---

[61] Marc Galanter & William Henderson, *The Elastic Tournament: A Second Transformation of the Big Law Firm*, 60 STAN. L. REV. 1867, 1906–07 (2008).

[62]

> Lawyers note that compensation shapes culture through the behaviors that it encourages and discourages. If a firm pronounces the importance of pro bono work but seems not to take it into account in setting compensation, it will be clear to lawyers that the firm does not regard time spent on pro bono matters as important. Similarly, if a firm provides compensation credit for a partner who takes on non-billable management responsibilities when he could be devoting that time to developing his own clients, the firm credibly signals that it values partners who are willing to make some personal sacrifices on behalf of the firm as a whole.

Milton C. Regan, Jr. & Lisa H. Rohrer, *Money and Meaning: The Moral Economy of Law Firm Compensation*, 10 U. ST. THOMAS L.J. 74, 80 (2012). For another powerful indication of the importance of a law firm's culture, see Jennifer Smith, *The Downside of Luring Lateral Partners*, WALL ST. J. LAW BLOG (Oct. 20, 2014 11:37 AM), http://blogs.wsj.com/law/2014/10/20/the-downsides-of-lurling-lateral-partners/ ("While money is of course one motivation for switching firms, the number one reason cited by survey respondents [of lateral partners] was firm culture.").

[63] Bernie Burk and Dave McGowan make this point in a wonderful article. *See* Burk & McGowan, *supra* note 49.

[64] Galanter & Henderson, *supra* note 61, at 1898.

[65] *Id.* at 1911 (quoting Kimberly Kirkland, *Ethics in Large Law Firms: The Principle of Pragmatism*, 35 U. MEM. L. REV. 631, 690 (2005)).

[66] *Id.* at 1907.

conspired to undo on-the-job learning. First, large firms have discovered that they could increase the number of associates dramatically while holding the number of partners steady. But this increase in leverage necessarily means that associates spend less time with—and learning from—more senior lawyers. As Henderson puts it, high leveraging "makes high quality training, mentoring, and monitoring infeasible."[67] The problem here is, of course, that the contemporary large law firm's default incentives run against the very sort of behavior that made them successful in the past:

> The increased reliance on leverage draws into sharp relief the tendency of Big Law to use its existing reputational capital to maximize short-term profits rather than take the steps necessary to build a stronger organization capable of taking market share from competitors. The higher leverage makes it much more difficult to properly screen, monitor, and train lawyers who are capable of building the firm's reputational capital. Further, when we layer on top the increased pressure to originate business—to either preserve one's standing in the firm or take advantage of rich payouts available to lateral partners—equity partners lack meaningful financial incentives to invest time in the mentoring of junior lawyers.[68]

And as Lawrence Fox astutely observes, the casualties from this process are readily identifiable and concrete:

> Loyalty is an early victim, as is the concept of the firm—all for one and one for all. Further, if the real rewards go to those with the biggest books of business, what happens to other firm responsibilities such as hiring, training, running a summer program, pro bono services, bar association work and a myriad of other areas of endeavor? They still might get done but they will be done by individuals who will be under-rewarded for their efforts, sadly reflecting the reality that law as business has driven out so much of what we valued and celebrated about law as a learned and committed profession.[69]

Then, too, as the number of technically sophisticated lawyers has increased (often outstripping demand), "[t]his reality strongly reduces the incentive of clients to subsidize the training of entry-level lawyers, particularly at inflated pay scales that are disconnected from the value provided to clients."[70] As Henderson and others have reported many times, some clients now refuse to pay for time billed by first- and second-year lawyers, which exacerbates the associate-development problem, because meaningful "briefcase carrying" represents money out of pocket for the firm.[71]

---

[67] Henderson, *supra* note 58, at 6.

[68] *Id.* at 10.

[69] Lawrence J. Fox, *The End of Partnership*, 33 FORDHAM URB. L.J. 245, 248 (2005).

[70] Henderson, *supra* note 60, at 380.

[71] *Id.* at 387. Adding to the problem, as large firms have migrated exclusively to premium work at premium prices, the steady flow of small cases and transactions that junior lawyers could once credibly handle with minimal supervision have evaporated. For a long period in which revenues increased dramatically almost every year, large firms filled the development gap with sophisticated (and expensive) professional development programs. Although these programs enjoyed some success, they also—not universally, of course—suffered from some

The takeaway from all this for new lawyers is that money (and the billable hours that generate it) matters *above all*, even though most everyone knows at some visceral level that a law firm "cannot credibly compete on the basis of quality when it underinvests in its most important asset—legal talent."[72] And that takeaway leads to another: that new lawyers aren't being trained in how to bill. If law firms want to remain ethical as well as solvent, they must be more responsive to the increasing client demands for transparency and economy. To both of us, that means that law firms must encourage habits that let even the newest lawyers bill ethically. So let's turn to virtue ethics as a way to encourage those habits.

II. VIRTUE ETHICS AND ITS RELATIONSHIP TO LAWYER BEHAVIOR

> *Virtue ethics holds one responsible for his or her choices and his or her actions, with the requisite consideration that these are affected by the facts, circumstances, and actual conditions of one's personal and professional existence in which morality operates. But more importantly, persons are held responsible for their character—the sum total of those* chosen *and* cultivated *traits from which such choices and actions arise. Cultivating one's personal and professional character, and thus acting in accordance with it, involves precisely the kind of intentionality that underlies the whole project of morality.*[73]

We're just two of many who have hopped on the virtue ethics bandwagon.[74] The basic gist of virtue ethics is that people are virtuous when they have created and follow habits of excellence—habits that inculcate behavior that mimic the behavior of the best among us.[75] By starting with the question of

---

of the same complaint-generating characteristics of law schools, in that they were often designed and run by non-lawyers or lawyers who had left practice after a short period. In any event, in recent years, many firms have "attempt[ed] to prop up profitability by slashing entry-level hiring and by cutting costs on professional development along with other nonessential expenses." *Id.* at 387–88.

[72] *Id.* at 388.

[73] Paul J. Saguil, *A Virtuous Profession: Re-Conceptualizing Legal Ethics from a Virtue-Based Moral Philosophy*, 22 WINDSOR REV. LEGAL & SOC. ISSUES 1, 10 (2006).

[74] *See, e.g.*, Andrew B. Ayers, *What if Legal Ethics Can't Be Reduced to a Maxim?*, 26 GEO. J. LEGAL ETHICS 1 (2013); Caryn L. Beck-Dudley & Steven H. Hanks, *On Virtue and Peace: Creating a Workplace Where People Can Flourish*, 36 VAND. J. TRANSNAT'L L. 427 (2003); Sherman J. Clark, *Law as Communitarian Virtue Ethics*, 53 BUFF. L. REV. 757 (2005); Ronald J. Colombo, *Toward a Nexus of Virtue*, 69 WASH. & LEE L. REV. 3 (2012); Clark D. Cunningham & Charlotte Alexander, *Developing Professional Judgment: Law School Innovations in Response to the Carnegie Foundation's Critique of American Legal Education*, *in* THE ETHICS PROJECT IN LEGAL EDUCATION, ch. 5 (Michael Robertson et al. eds., 2011); Adrian Evans & Michael King, *Reflections on the Connection of Virtue Ethics to Therapeutic Jurisprudence*, 35 U.N.S.W. L.J. 717 (2012); Saguil, *supra* note 73, at 1.

[75] In virtue ethics, the "how" is by means of character and virtue. To virtue ethicists, one ought to live life "excellently," which, in turn, will further the individual's, and society's, happiness and well-being. Indeed, the classical ethicists on whose shoulders modern

how an "excellent" person (in the Aristotelian sense)—in our case, an excellent lawyer[76]—would behave in a particular situation, we can work backwards to determine how to develop the habits that would make it more likely to lead to the right behavior.[77] The trick, of course, is to identify just what habits a virtuous biller might have, so that we could emulate those habits. We will go on to identify techniques for monitoring and improving billing practices, but we also suggest that observing the way that the very best lawyers bill would be a good starting point. The assumption here is that virtuous and ethical lawyers will carry their good habits across the whole of their practices.[78]

Neither of us is wedded to the idea that developing habits alone will counteract all of the cognitive pressures that humans encounter.[79] It's probably more reasonable to assume that the combination of ethical habits and an awareness of cognitive errors is a better way to shape lawyer behavior.[80] Those cognitive errors[81] can include cognitive dissonance,[82] diffusion of responsibility,[83] and so-

---

> virtue ethicists stand, endeavored to answer the question: "What is a good life for a human being?"; not the more direct and mundane question: "What ought I to do?"

Colombo, *supra* note 74, at 10 (footnotes omitted); *see also* Michael S. McGinniss, *Virtue Ethics, Earnestness, and the Deciding Lawyer: Human Flourishing in a Legal Community*, 87 N.D. L. REV. 19, 34 (2011) ("[A] virtue ethicist derives the rules of action for persons of good character from the virtues themselves, rather than establishing a duty-based rule of action first and deciding whether a person is acting in good character solely by determining whether he has acted in conformity with the rule." (footnote omitted)).

[76] The concept of the Aristotelian "excellent lawyer" is different from, say, a lawyer who goes around thinking of herself as an excellent lawyer in general. There's a difference between someone who has confidence in her own skills ("I'm an excellent lawyer") and someone who thinks of herself as so good that she doesn't need to pay attention to the ethics of what she's doing.

[77] McGinniss, *supra* note 75, at 32.

> How does a virtue ethicist go about making moral decisions? First, before asking "what should I do?," a person faced with a moral dilemma should ask "what kind of person should one be?" For a virtue ethicist, the answer is that one should be a person of good and virtuous character whose actions are consistent with that character.

Id. (footnote omitted).

[78] *See* Lorie M. Graham, *Aristotle's Ethics and the Virtuous Lawyer: Part One of a Study on Legal Ethics and Clinical Education*, 20 J. LEGAL PROF. 5, 48 (1995–96).

[79]

> We can now see the important implications of the person-situation debate for character-based moral theories. The virtue ethics tradition relies on the existence—and presumably on some sort of behavioral manifestation—of character traits. As Owen Flanagan puts it, "the entire enterprise of virtue ethics depends on there being individual traits of character which are causally effective in the production of behavior across situations of a kind." But if Situationism is right, human behavior should not be understood as flowing from settled character and, hence, virtue ethicists hold an empirically inadequate conception of character traits and, presumably, a normatively wrong notion of moral character.

Miguel Alzola, *Character and Environment: The Status of Virtues in Organizations*, 78 J. BUS. ETHICS 343, 347 (2008) (citations omitted).

[80] *Cf. id.* at 352–53. ("In any event, there is a middle way between Situationism and Dispositionalism in organizational scholarship and business ethics. The empirical data support a synthetic theory of behavior according to which both of these viewpoints reflect important aspects of the truth.").

[81] One of us has discussed cognitive errors a fair amount, most recently in Rapoport, *supra* note 6, at 44.

cial pressure.[84] We don't expect that an awareness of cognitive errors will change the way that humans are hard-wired to think, and we don't think that developing ethical habits will make someone more ethical. But we do believe that—if we had to choose between trying to make someone who's not particularly ethical into someone who is actually ethical and developing systems that make even the not-ethical person behave as if he were ethical—we'd pick the latter. We don't mind tilting at windmills,[85] but we'd rather attack real problems that might have real solutions.

III. A RECAP: INCENTIVES AND THEIR EFFECTS ON BILLING BEHAVIOR

As a general rule, employees respond to the incentives that their employers give them.[86]

The trick with incentives is that people may think that they're shaping behavior one way, but the very incentives that they put into place often trigger unintended consequences that counteract the behavior they want to elicit.[87] In terms of lawyer billing behavior, hourly billing is a perfect example.[88]

---

[82] For an armchair description of cognitive dissonance, see, e.g., Kendra Cherry, *What Is Cognitive Dissonance?*, ABOUT.COM, http://psychology.about.com/od/cognitivepsychology/f/dissonance.htm (last visited Feb. 23, 2015).

[83] *See, e.g.*, Kendra Cherry, *What Is Diffusion of Responsibility?*, ABOUT.COM, http://psychology.about.com/od/dindex/f/diffusion-of-responsibility.htm (last visited Feb. 23, 2015).

[84] *See, e.g.*, Saul McLeod, *Asch Experiment*, SIMPLYPSYCHOLOGY (2008), http://www.simplypsychology.org/asch-conformity.html (last visited Feb. 23, 2015).

[85] *Cf.* MIGUEL DE CERVANTES SAAVEDRA, DON QUIXOTE 44–45 (Wordsworth Editions Ltd., 1998) (1605).

[86] Rapoport, *supra* note 6, at 44.

[87] One way to think about the problem of unintended consequences is to think about "latent functions":

> There are essentially two methods for attributing goals to a law-related system, the "positive" and the "normative." The positive method is to observe the operation of the system, determine what results it is in fact bringing about, and then to assume that it intends to bring about those results. Careful empirical observation of a law-related system almost always reveals that the system is doing things and producing results that participants in the system did not intend or anticipate. Systems-oriented sociologists refer to them as "latent functions." Despite their unexpected nature, it is appropriate to treat these results as intended.

Lynn M. LoPucki, *The Systems Approach to Law*, 82 CORNELL L. REV. 479, 502–03 (1997) (footnotes omitted) (citing to, among other sources, ROBERT K. MERTON, SOCIAL THEORY AND SOCIAL STRUCTURE 63 (1957)). Thanks to Peter Bayer for pointing this idea out. For a slightly icky discussion of perverse incentives, see Rapoport, *supra* note 6, at 108 n. 227 (discussing the "rat tail" example of how incentives can trigger the exact opposite behavior that the incentives were designed to elicit).

[88] Studies of law as one of the "learned" professions (classically: medicine, law, and the clergy) naturally compare lawyers and physicians. *See, e.g.*, SULLIVAN ET AL., *supra* note 46. For many years, medicine seemed to maintain a degree of insulation from the encroachment of "business" motives and evaluative standards. In recent years, though, medicine has been infected with its own version of the billable-hour virus, which has come in the forum of reimbursement schedules tied to the amount of time that a payer says should have been spent on a particular consultation or procedure. *See* CMS MANUAL SYSTEM, CTRS. FOR MEDICARE

Lawyers developed hourly billing as a way of reassuring clients that the work that they were doing for the clients was reasonable.[89] In a study of the economics of hourly billing, George Shepherd and Morgan Cloud suggested that the shift to hourly billing from fixed-fee billing stemmed from a change to more liberalized discovery rules.[90] The documentation of time spent on a particular matter—as opposed to the classic one-line bill of "for services rendered, $*x*"[91]—gave clients a way to measure the effort that the lawyers had expended. This client-centric[92] development, though, then became a way for a law firm to "measure . . . the utility of the worker and . . . the success of the firm itself."[93]

& MEDICAID SERVS., DEP'T HEALTH & HUMAN SERVS. § 20.2(C) (2010), *available at* https://www.cms.gov/Regulations-and-Guidance/Guidance/Transmittals/downloads/R2121CP.pdf. But there is a difference: in law, incremental billing is intended to serve as a damper on how much a client must pay (but provides an incentive to pile up more billable hours); in medicine, incremental billing is also intended to keep costs down (but provides an incentive to spend as little time as possible with a patient). *See* David Frenz, *Is Time Really on Your Side?*, TODAY'S HOSPITALIST, Aug. 2012, *available at* http://www.todayshospitalist.com/index.php?b=articles_read&cnt=1515 ("Hospitalists are also generally aware that they can bill based on time. While seemingly attractive—think of that chatty patient or family member who won't let you escape—there are caveats and headaches that reduce its utility."). For all we know, the clergy has (or will!) implement time-based efficiency metrics.

[89] Susan Fortney made a related point to one of us in an email. *See* E-mail from Susan Fortney, Dir., Inst. for the Study of Legal Ethics, to Nancy Rapoport, (June 29, 2014, 6:40 PM) [hereinafter Fortney E-mail] (on file with author Rapoport) ("On the development of billable hour practice, I believe that consultants actually promoted billable hour practice as a way for lawyers to capture their efforts and make more money.") (draft attached to email).

[90] *See* George B. Shepherd & Morgan Cloud, *Time and Money: Discovery Leads to Hourly Billing*, 1999 U. ILL. L. REV. 91, 94.

> The profession was pushed irresistibly to hourly billing by economic pressures that resulted from the introduction of rules that permitted wide-open pretrial discovery. By creating unbearable cost uncertainty for lawyers who handled litigation matters, wide-open discovery forced lawyers, and surprisingly their institutional clients, to demand that the traditional forms of fixed fees be abandoned in favor of hourly billing.

Id. (footnote omitted). Kudos to Bernie Burk for pointing us in this direction.

[91] *See, e.g.*, Stuart L. Pardau, *Bill, Baby, Bill: How the Billable Hour Emerged as the Primary Method of Attorney Fee Generation and Why Early Reports of its Demise May Be Greatly Exaggerated*, 50 IDAHO L. REV. 1, 2–6 (2013).

[92] Well, hourly billing was also a way for lawyers to cost-shift to clients the risks of underpricing an engagement. *See* Shepherd & Cloud, *supra* note 90, at 95–96.

> As cost uncertainty increases, the lawyer's risk-bearing costs under the fixed-fee contract increase. If cost uncertainty increases sufficiently, then the risk costs that the fixed-fee contract imposes on the lawyer will eventually exceed the fixed-fee contract's moral-hazard-reducing benefits. At that point, the lawyer will be better off under hourly billing, even after compensating the client for accepting the cost uncertainty and the moral hazard.

Id.

[93] Dennis Curtis & Judith Resnik, *Teaching Billing: Metrics of Value in Law Firms and Law Schools*, 54 STAN. L. REV. 1409, 1412 (2002) (reviewing DEBORAH L. RHODES, IN THE INTERESTS OF JUSTICE: REFORMING THE LEGAL PROFESSION (2000))

> Hours are a factor in deciding salary levels, raises, bonuses, and promotions. Firms may also use hourly records to equalize work among associates, to calculate "utilization" of associates (how associates are measuring up to the firm's hourly requirements), and to calculate a "realization" figure (how much the firm has actually collected for an associate's work).

Id.

The more billable hours racked up (at least, the more billable hours that resulted in income for the firm), the better off the firm expected its finances to be.

Billable hours can provide some information about how "productive" a lawyer is and how profitable her firm is[94]—but, to paraphrase Jane Austen,[95] it is a truth universally acknowledged that when firms base their reward structures on billable hour totals,[96] they're encouraging billing abuse, which is a particularly virulent form of unethical behavior.[97]

When we say "unethical," we don't mean that the behavior is intentionally dishonest.[98] (Some billing errors are dishonest, of course, but many billing errors are inadvertent.) Cognitive errors such as cognitive dissonance and social

---

[94] *See, e.g.*, Jesse Nelman, *A Little Trust Can Go a Long Way Toward Saving the Billable Hour*, 23 GEO. J. LEGAL ETHICS 717, 722 (2010) ("The billable hour can be salvaged through education in the form of modest regulation and the development of proper billing judgment for associates. This approach will provide lawyers with the notice and guidance they need to develop and sustain ethical billing practices despite pressure to perhaps do otherwise.").

[95] JANE AUSTEN, PRIDE AND PREJUDICE 3 (Arc Manor 2008) (1813) ("It is a truth universally acknowledged, that a single man in possession of a good fortune, must be in want of a wife.").

[96]
> Objective compensation systems that do not recognize and reward other contributions, such as management and supervision time, discourage partners from devoting time to such activities. Attorneys functioning in such a system face tremendous pressure to bill hours and generate business, making it difficult for them to devote time to "non revenue" producing endeavors, such as training and supervision. As described by Professor Patrick Schiltz, the "pressure to bill hours—pressure to 'bill or be banished'—is necessarily pressure not to mentor." Similarly, the emphasis on business generation can undermine meaningful supervision because an "hour devoted to bringing in business is valued much more today than an hour devoted to mentoring a junior colleague."

Susan Saab Fortney, *Soul for Sale: An Empirical Study of Associate Satisfaction, Law Firm Culture, and the Effects of Billable Hour Requirements*, 69 UMKC L. REV. 239, 281–82 (2000) (footnotes omitted). Prof. Fortney, in commenting on an earlier draft of this article, noted that billing abuses are more likely when billing partners are "unwilling or unable to monitor the bill." Fortney E-mail, *supra* note 89.

[97] Lots of people have tried to parse out why lawyers overbill. For example, James Schratz did an interesting piece in the late 1990s talking about possible psychological reasons for overbilling. James P. Schratz, *I Told You to Fire Nicholas Farber—A Psychological and Sociological Analysis of Why Attorneys Overbill*, 50 RUTGERS L. REV. 2211 (1998); *see also* Adam C. Altman, *To Bill, or Not to Bill?: Lawyers Who Wear Watches Almost Always Do, Although Ethical Lawyers Actually Think About It First*, 11 GEO. J. LEGAL ETHICS 203 (1998); Susan Saab Fortney, *The Billable Hours Derby: Empirical Data on the Problems and Pressure Points*, 33 FORDHAM URB. L.J. 171 (2005); Lawrence J. Fox, *Save Us from Ourselves*, 50 RUTGERS L. REV. 2189 (1998); Lisa G. Lerman, *Blue-Chip Bilking: Regulation of Billing and Expense Fraud by Lawyers*, 12 GEO. J. LEGAL ETHICS 205 (1999); Pardau, *supra* note 91; Jennifer K. Robbennolt & Jean R. Sternlight, *Behavioral Legal Ethics*, 45 ARIZ. ST. L.J. 1107, 1130–31 (2013); William G. Ross, *The Ethics of Hourly Billing by Attorneys*, 44 RUTGERS L. REV. 1 (1991); W Bradley Wendel, *In Search of Core Values*, 16 LEGAL ETHICS 350 (2013).

[98] *See* Lisa G. Lerman, *A Double Standard for Lawyer Dishonesty: Billing Fraud Versus Misappropriation*, 34 HOFSTRA L. REV. 847, 868–69 (2006) (distinguishing between types of billing mistakes that do, and don't, involve dishonesty).

pressure[99] can lead lawyers to make choices that benefit themselves more than they do the client. Lisa Lerman provides a useful example of the way in which subconscious choices can cost a client money:

> [A lawyer] offered as an example one situation in which a company hired his firm and another firm to work on two very similar matters. His firm "did an exhaustive $100,000 job and produced a two-inch binder filled with memos. The other firm did a fifteen page memo that cost about $5,000." The client was "initially kind of horrified at the difference."
>
> In explaining how this happened, [the interviewed lawyer] said, "It had something to do with the fact that the partner who had the matter in our firm felt that he had to get his billings up—thought he had to make a strong impression on the firm at that point in his career. And he had people around who could do the work for him."[100]

Had the lawyer doing the $100,000 job made a habit of asking himself if he could do the work faster and cheaper, maybe the client wouldn't have been stuck with a large bill. On the other hand, maybe the incentives within that law firm discourage its lawyers from developing such a habit: those types of habits likely make it more difficult for law firms to turn a profit. Both of us have faced the pressures of having to bill significant hours, and we both believe that those pressures can be inordinate in a climate of shrinking law firm profits. To us, the pressures caused by the hourly billing metric demonstrate that "the situation" can cause more problems than could possibly be blamed on "bad" people. It's not character;[101] it's context.

Even when a lawyer wants to behave appropriately and bill accurately, a firm's use of incentives that are based on hourly billing metrics will put lawyers who work efficiently at a disadvantage.[102] In 2000, Susan Saab Fortney conducted a survey of one thousand Texas associates, who had been licensed for no more than ten years and who worked in firms of more than ten attorneys.[103] Some of her respondents described the types of problems (the competitive disadvantages that efficient lawyers face; the pressure to lie; the tendency toward self-deception) created by using billable hours as the main metric for rewards.[104] Her 2005 study reinforced her earlier findings.[105] On the one hand,

---

[99] Rapoport, *supra* note 6, at 58–59 & nn.55–61 (describing cognitive dissonance, diffusion of responsibility, social pressure, and anchoring errors as they might relate to lawyer behavior).

[100] Lisa G. Lerman, *Lying to Clients*, 138 U. PA. L. REV. 659, 707 (1990) (footnote and alterations omitted).

[101] Well, ok: sometimes, it's character.

[102] Susan Fortney reported this observation in, among other articles, Fortney, *supra* note 97, at 177–78 (linking the incentives of billable hours to overwork).

[103] Fortney, *supra* note 96, at 243–44 (reporting a final response rate of 55.2 percent). For an Australian survey of billable hour issues, see generally Christine Parker & David Ruschena, *The Pressures of Billable Hours: Lessons From a Survey of Billing Practices Inside Law Firms*, 9 U. ST. THOMAS L.J. 619 (2011).

[104] Fortney, *supra* note 96, at 279; *see also id.* at 275 (associate pointing out that the quest for high billable hours leaves no room for discussion about the quality of the work).

the more efficient lawyer will have more time to take on more projects, because she can complete her work in a shorter time; but she will also face the pressure of her peers if she consistently demonstrates that they might be working too slowly, and she may resent the fact that she's working harder than some of her peers.

We've read articles about the unseemly side of billing by the hour, such as the story about a law firm being sued by its client for overbilling.[106] When a major firm sends emails[107] that say, "Churn that bill, baby" and "That bill shall know no limits," something is off-kilter. That behavior is venal. But even when a firm discourages such unethical behavior, the pressures of law firm economics and the metrics of hourly billing create temptations.

To be fair, law firms have to be able to make a profit, and to make a profit, they have to be able to cover salaries, partner draws, and overhead. The higher the fixed costs (and, for that matter, the variable costs), the more likely it is that a firm will decide not to scrutinize certain billing behaviors too closely unless it is forced to do so by, say, a court.[108] But there is a practical reason for a law firm to think hard about how its incentives can affect its employees' behavior: billing mistakes that lead to client dissatisfaction will result in less income to the firm. Hours that are improperly billed are lost forever. There's no way to recoup that lost time if the client refuses to pay for it. So part of a firm's responsibility is to think hard about how its incentives affect the quality of its work product and the behavior of its employees; another part is to think about how to inculcate the habits that will help its employees behave ethically as consistently as possible.

---

[105] *See generally* Fortney, *supra* note 97 (2005).

[106] *See* Peter Lattman, *Suit Offers a Peek at the Practice of Inflating a Legal Bill*, DEALBOOK, N.Y. TIMES (Mar. 25, 2013, 3:36 PM), http://dealbook.nytimes.com/2013/03/25/suit-offers-a-peek-at-the-practice-of-padding-a-legal-bill/. For the law firm's internal memo stating that the emails were intended as a joke, see David Lat, *Overbilling Gone Wild: Paying the (DLA) Piper*, ABOVE THE LAW, http://abovethelaw.com/2013/03/overbilling-gone-wild-paying-the-dla-piper-plus-interesting-lateral-moves-into-and-out-of-dla/2/. For a story discussing the confidential settlement, see Peter Lattman, *Settling Fee Dispute, Law Firm Denounces 'E-Mail Humor,'* DEALBOOK, N.Y. TIMES (Apr. 17, 2013, 6:18 PM), http://dealbook.nytimes.com/2013/04/17/law-firm-dla-piper-settles-accusation-of-overbilling/.

[107] Or, more accurately, when lawyers at the firm are dumb enough to send such emails.

[108] For a cautionary tale of a firm that ignored several red flags of one of its highest billing partners, see MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER (2004). *See also* Nancy B. Rapoport, *The Curious Incident of the Law Firm That Did Nothing in the Night-Time*, 10 LEGAL ETHICS 98 (2007) (reviewing MILTON C. REGAN, JR., EAT WHAT YOU KILL: THE FALL OF A WALL STREET LAWYER (2004)); Curtis & Resnik, *supra* note 93, at 1421.

> If the system of required hours makes it likely that associates will cheat, it is equally likely that firms will not monitor the associates closely because the firms stand to benefit from the hours logged. Incentives for firms to be above reproach in financial dealings with clients are undermined by the increasing difficulty for law firms to remain solvent while continuing to meet (or to set) market rates in paying partners and associates.

Id.

IV. THE VIRTUOUS BILLER[109]

Judge Schiltz has described the powerful impact his mentor, James Fitzmaurice, had on his own ethical and moral development as a lawyer:

> *Fitzmaurice did not teach me to practice law ethically through his words. I do not recall him ever saying, "This is what an ethical lawyer does." Rather, he taught me through his deeds. He taught me by being a decent man who practiced law every day in a decent manner. Moral formation "rests on small matters, not great ones," and what I recall most about Fitzmaurice are "the small matters":*
>
> *I recall how Fitzmaurice would take strident letters or briefs that I had drafted and tone them down. I recall how Fitzmaurice would run into an attorney who had treated him shabbily and greet the attorney warmly. I recall how Fitzmaurice would time and again refer clients and files to young lawyers in our firm who were having trouble attracting business. I recall how Fitzmaurice never blamed others for his mistakes, but often gave others credit for his accomplishments. I recall how often Fitzmaurice took the blame for mistakes that I and other young attorneys made. I recall how Fitzmaurice, at the conclusion of a trial or hearing, would walk over to the client of his adversary and say, "I just want you to know that your attorney did a terrific job for you." In short, what I best recall about Fitzmaurice were not occasions of great moral heroism, but his "quiet, everyday exhibitions of virtue." It was through such exhibitions that he helped shape my character and instill in me the habit of acting ethically.*[110]

Let's assume that we want to describe the virtuous biller.[111] What habits might he or she have that makes the lawyer a virtuous biller? Paul Saguil has set out his concept of the legal "virtues": judgment, empathy, integrity/honesty, passion/engagement, diligence, and creativity/innovation.[112] Those six categories seem to be a good place to start.

---

[109] One way to think about billing virtues is by doing a jazz riff off Larry Solum's article about judicial virtues. *See* Lawrence B. Solum, *A Tournament of Virtue*, 32 FLA. ST. U. L. REV. 1365 (2005).

[110] McGinniss, *supra* note 75, at 55 (quoting Patrick J. Schiltz, *Legal Ethics in Decline: The Elite Law Firm, the Elite Law School, and the Moral Formation of the Novice Attorney*, 82 MINN. L. REV. 705, 738 (1998)).

[111] The virtuous biller "must both 'walk the talk' *and* 'talk the walk'—making sure that behavior is consistent with other messages about ethics." Robbennolt & Sternlight, *supra* note 97, at 1170.

[112] Saguil, *supra* note 73, at 18–23.

A. Billing Judgment

A virtuous biller exercises billing judgment by deciding what *not* to bill to the client—either before the work has been done or afterwards (but before the bill goes to the client).[113] Deciding what not to bill before the work is done requires thinking strategically about what the client needs, not just in the abstract but also with due consideration of the client's budgetary and non-monetary concerns.[114] Does the client need salaried (and thus more expensive) first-year associates to review documents, or can contract attorneys suit the client's needs? Does the client need a typeset closing binder, or will a nicely bound word-processed binder do just as well? If a lawyer jumps down a rabbit hole[115] to pursue a legal theory that ultimately does nothing to advance the client's position, should the billing partner bill all of that time to the client, part of it, or none of it?[116] Should all interoffice conferences be billed, or just some of them?[117] The virtuous biller uses judgment at two stages: when deciding what work to do, and when reviewing the bill after the work has been done. The latter stage is imperative, and the former stage will save the firm from wasted and uncompensated effort.[118]

---

[113] To be more precise, the lawyer in charge of preparing a bill should be the one exercising billing judgment. Subordinate lawyers may not have the skill set or knowledge to exercise such judgment. In commenting on an earlier draft, our friend Ron Colombo suggested that we should advert to the possibility that a firm might encourage a lawyer to "underbill" for all sorts of reasons, in addition to creating incentives that might encourage overbilling. *Cf.* E-mail from Ronald J. Colombo, Professor, Maurice A. Deane Sch. of Law, Hofstra Univ., to Nancy Rapoport (Aug. 28, 2014, 12:48 PM) (on file with author Rapoport). As Professor Colombo puts it, "virtue would seem to include not only avoiding the temptation to overbill, but the potential temptation to underbill as well." *Id.* We get his point that we should discuss both overbilling and underbilling to make sure that we cover all of the bases. Maybe law firms do underbill, at least in part, when they cut their "rack rate" hourly rates; on the other hand, maybe the "rack rate" has achieved mythic proportions because most clients don't pay that rate as often as they once did. (For a discussion of the downward pressures that clients are placing on law firm fees, see, e.g., Nancy B. Rapoport, *The Case for Value Billing in Chapter 11*, 7 J. BUS. & TECH. L. 117, 142–48 (2012)). So we take his point, but we doubt that any client will ever complain about underbilling. Moreover, because neither of us believes that the billable hour represents a true value of the legal services rendered, we're advocating for the billing judgment that recognizes that the "value" of legal services is in the eye of the client more than in the eye of the lawyer.

[114] It's all well and good for a client to say, "it's a matter of principle, no matter how much it costs," but typically the client says that *before* he receives the bill.

[115] *Cf.* LEWIS CARROLL, ALICE'S ADVENTURES IN WONDERLAND 3 (two vols. in one, 1906).

[116] Maybe the lawyer should bill the client for all of the research, on the theory that knowing that an approach might not be fruitful is still useful information; we're agnostic about that issue as long as the billing partner makes such a decision after thinking long and hard about whether billing for ultimately useless research was in the client's best interest.

[117] *See* J. Scott Bovitz, *Being a Great Lawyer (as a Partner)*, *in* NANCY B. RAPOPORT & JEFFREY D. VAN NIEL, LAW FIRM JOB SURVIVAL MANUAL: FROM FIRST INTERVIEW TO PARTNERSHIP 176–77 (2014) (encouraging the "no charge" notation on bills).

[118] *See* Fortney E-mail, *supra* note 89 (observing that virtuous lawyers will review bills with an eye toward benefitting the client and non-virtuous lawyers will review bills with an eye toward benefitting themselves).

B. Billing Empathy

When we refer to "empathy," we refer to a lawyer's ability to see the bill from the client's perspective.[119] Different clients will have different levels of sophistication in reviewing their legal bills. Large institutional clients who have experienced in-house counsel (especially those who used to work at big law firms) will read a bill differently from the client who is encountering a legal bill for the first time. Empathy in billing is related to billing judgment in terms of what might get written off before the client gets the bill, but it also relates to the level of explanation that goes into the bill itself.

Lawyers who have lived and breathed a case sometimes have a hard time looking at a legal bill as a way of telling the client the story of what they did for the client. "Review file" tells no story at all.[120] "Review docket to determine status of motion to disqualify" does. A virtuous biller would read each line of a bill to make sure that the bill gives the client a complete and accurate picture of what happened.

C. Billing Integrity/Honesty

Even people who don't use "virtue" in the Aristotelian sense will agree that billing virtue must include being honest about what the biller did for the client and being aware that all decisions about what to do—and not to do—on a matter should start with the principle that a lawyer is a fiduciary for her client. Decisions on what to do should start and end with the client's needs, not the lawyer's needs. If the lawyer is low on hours for the month, quarter, or year, that's the lawyer's problem, not the client's.[121]

Part of billing integrity/honesty must include serious training in how and what to bill.[122] The virtue of billing with honesty is a virtue for the supervising partner and for each billing professional.[123] What may seem intuitive to a veteran lawyer (when and what to bill) can confuse the novice lawyer. New employees need to know the rules for hourly billing: when does the clock start and

---

[119] Our colleague Jean Sternlight pointed out, in reviewing an earlier draft of this article, that unsophisticated clients might think that a reasonable bill is unreasonable, and that adjusting the bill in such a situation isn't necessarily the right reaction (although explaining the bill would be important).

[120] Rapoport, *supra* note 6, at 86 ("'[A]ttention to file' has never told a single client what the biller actually did.").

[121] *See* Lisa G. Lerman, *Scenes From a Law Firm*, 50 RUTGERS L. REV. 2153, 2158 (1998) (describing how a lawyer can create make-work projects and overbill for them). *But see* Fortney, *supra* note 96, at 280 ("Professor Ross contends that most over billing is the result of self-deception rather than conscious fraud.").

[122] Supervising lawyers have a duty to ensure that their employees are behaving ethically. *See* MODEL RULES OF PROF'L CONDUCT R. 5.1 (2011) (detailing the responsibilities of a partner or supervisory lawyer). For a discussion of practical billing ethics, see, e.g., RAPOPORT & VAN NIEL, *supra* note 117, at 61–64.

[123] If we were smart alecks, we'd also refer to "excellent law firms" as if the firms were people. OK, we're a little bit smart-alecky.

stop? What's the minimum billing increment? What happens when the minimum billing increment is still too large to use for a very short task, such as the gap between leaving a thirty-second message and a minimum 0.1-hour billing increment?[124] Is thinking about the client while getting a cup of coffee billable time? If a lawyer spends an hour thinking about the right strategy for a matter, can the lawyer write "thinking" as the billing description?[125] How can a firm reward time spent on non-billable activities?[126] One of us has suggested that the easier it is for a timekeeper to enter information, the more likely it is that the timekeeper will do so contemporaneously.[127] And we both believe that lawyers who join a firm—either as novices or as laterals—need to have training in that firm's policies.

But we acknowledge that every minute spent training new lawyers is a minute that can't be spent doing other things that a firm needs its senior lawyers to do: work on their clients' matters, generate new business, think about strategic planning, and the like. Law firms these days are squeezed by clients—it's a buyer's market—and not particularly aided by law schools, which can't provide the type of hands-on training to all of their students that those students taking clinics will get. Could law schools do a better job of giving students a broader range of skill sets, and maybe some billing training? Maybe, but many law professors just don't have an up-to-date connection to the practice of law to provide useful, practical, bread-and-butter training to their students.[128] So we're

---

[124] Questions also relate to what could be called "phantom time." Most firms do not have measures of actual time spent but bill in *units* of time, with rounding off (possibly rounding down but most often rounding up). In most large firms, the minimum unit ranges between six minutes (a tenth of an hour) to fifteen minutes (a quarter of an hour). If all tasks are charged, a one or two minute phone call, even if only to leave a message, could be billed as a quarter hour. An email sent or read similarly can produce bills of a tenth or a quarter of an hour. At the end of the day, a lawyer may have accumulated a wealth of hours and a list of charges, well in excess of the actual hours the lawyer spent in the office.

Curtis & Resnik, *supra* note 93, at 1416–17.

[125] Personally, we think that an hour of time spent "thinking"—when done by someone who is demonstrably experienced and creative—isn't a bad idea, but we still think that the description should be fleshed out.

[126] Fortney, *supra* note 97, at 179.

> Respondents frequently commented on employer emphasis on billable hours production and the pressure to clock long hours. In struggling to meet billing expectations or targets, respondents explained the additional time commitment associated with completing non-billable tasks such as recruiting, training, speaking, writing, and marketing. Some noted that this non-billable work does not receive credit or consideration for bonus purposes.

Id.; *see also* Rapoport, *supra* note 6, at 98–102 (discussing possible incentives to encourage non-billable, but important, work).

[127] *See* Rapoport, *supra* note 6, at 85–86.

[128] Nor are most full-time faculty members allowed to have that type of current knowledge—at least not on a deep level. *See* ABA STANDARDS AND RULES OF PROCEDURE FOR APPROVAL OF LAW SCHOOLS 2013–2014 § 402(b) (2013) ("A full-time faculty member is one whose primary professional employment is with the law school and who devotes substantially all working time during the academic year to the responsibilities described in Standard 404(a), and whose outside professional activities, if any, are limited to those that relate to major academic interests or enrich the faculty member's capacity as a scholar and

sympathetic to the pressures that law firms face as they decide how they're going to train their timekeepers.[129]

D. Billing Passion/Engagement

If "engagement" refers to paying attention to what one is doing—to being fully in the moment—then the virtuous biller will monitor what's going on in each matter, not just when reviewing the bill but also while the work is being done. She will monitor the matter to make adjustments to staffing and projects when circumstances change, and she will communicate to her client about those adjustments.[130]

E. Billing Diligence

A virtuous biller doesn't wait until the end of the month[131] to describe what he did for his clients.[132] Waiting too long to record time is bad for the lawyer (he may forget to record some time)[133] and bad for the client (if the lawyer overestimates the time that he spent on a task). Instead, the virtuous lawyer creates habits that force him to record his time contemporaneously. When those

---

teacher, are of service to the legal profession and the public generally, and do not unduly interfere with one's responsibility as a faculty member.").

[129] As Bernie Burk put it in an email to one of us:

> The choice is not between bearing and avoiding a cost (training); it's between bearing training costs and bearing the larger, more pervasive and more damaging (if harder to quantify and identify, and thus subject to cognitive bias) costs of having untrained lawyers. [T]he fact that the current state of the economics of the profession means that partners have to choose between a smaller cost and a bigger cost sucks for them, but that's the reality and when in doubt it's better to face reality than ignore it.

E-mail from Bernard A. Burk, Professor, U.N.C. Sch. of Law, to Nancy Rapoport (July 6, 2014) (on file with author Rapoport).

[130] And, when appropriate, she will seek her client's permission before making those adjustments.

[131] Or even until the end of the day.

[132]

> Submitting late timesheets created two serious problems: first, without a record of billable hours, billing partners couldn't send timely and complete bills to their clients; second, without making a contemporaneous record of what a lawyer had spent his or her time doing, developing those detailed records was an ethically risky proposition. There may have been some lawyers who could think back several weeks and belatedly record their work down to small slices of an hour, but they would have needed a superhuman memory to have done so accurately. Either they underestimated their work, or they overestimated it. The pressure to bill at least 1,800 (or 2,200, or 2,600, or more) hours a year likely meant that the scale of "filling in the blanks" created at least a subconscious incentive to overestimate the time spent on a given task.

Rapoport, *supra* note 6, at 51–52 (footnotes omitted).

[133] In other words, the lawyer makes a misrepresentation by making up entries to reflect what he "recalled." That misrepresentation is bad, and in certain circumstances (involving reasonable reliance), such misrepresentation can rise (or sink, as the case may be) to outright fraud, of both the civil and criminal variety.

habits are combined with the correct incentives for contemporaneous descriptions of his work, the odds of the bill's accuracy go up dramatically.[134]

F. Billing Creativity

We won't go so far as to say that a virtuous biller will eschew all billing by the hour,[135] but we will say that a virtuous biller will consider alternative forms of determining how to set her fees. Contingency fees are an example;[136] flat fees are another;[137] success fees are yet another.[138] The trick in setting a reasonable fee[139] is that it should reflect the relationship between work done and value provided, keeping in mind risk factors that include the client losing, the client becoming insolvent, and the other side refusing to pay, as well as the amount of time devoted to the matter (on the theory that—for most lawyers—there are only twenty-four hours in a day, and work done for one client precludes other uses of that time).

One other issue of billing creativity deserves mention here. Law firms should train their associates.[140] Training is not cost-free, and clients have started to push back hard on the idea that they should pay for the training.[141] That pushback leaves law firms with two choices: absorb training costs, or stop training associates. The virtuous biller will write off training time, in the belief that investing in associate training will pay off in the long term.[142]

---

[134] Susan Fortney has pointed out two other advantages: "The ethical lawyer who reconstructs time will shortchange him[-] or her[ ]self. Also contemporaneous billing enables a lawyer to testify that she always records as she goes along." Fortney E-mail, *supra* note 89.

[135] After all, each of us bills at least a part of our time that way.

[136] But contingency fees can also sometimes lead to unethical settlements that can benefit the lawyer more than the client.

[137] Flat fees, though, can create an incentive to stop working once the case is no longer profitable for the lawyer—which is, of course, unethical.

[138] And success fees can create an incentive to craft solutions that will trigger those fees.

[139] Fees must be reasonable. *See* MODEL RULES OF PROF'L CONDUCT R. 1.5(a) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses.").

[140] We both believe that law schools don't provide sufficient "real-world" training for their students to be able to hit the ground running as soon as they get their law licenses.

[141] *See, e.g.*, Fortney, *supra* note 97, at 189 ("Faced with intense pressure to reduce amounts expended for outside counsel, many of these approaches involved cost-cutting measures, such as using independent legal auditors, task-based billing, and research outsourcing. . . . Surveys of general counsel reveal that their most pressing concern is controlling the costs of outside counsel."); *see also* Rapoport, *supra* note 6, at 99 & n.192 ("[L]aw firms now neither provide significant observation experience nor write off as much time as they used to; moreover, those clients with good bargaining power are starting to refuse to pay for first- and second-year associate time."); *cf.* Rapoport, *supra* note 113, at 145–46 ("The days of clients blithely acquiescing to skyrocketing hourly rates and burgeoning staffing of projects (if, indeed, those days ever existed) are gone.").

[142] That investment pays off well when the associate stays at the firm and becomes a good lawyer; it pays off less well when the associate leaves.

G. Billing Virtues Versus Billing Vices

Now that we have some basic descriptions of the billing virtues, it's useful to compare the virtues to their opposites, the billing vices.

TABLE 1: BILLING VIRTUES AND CORRESPONDING VICES

Billing virtue	Billing vice
Billing judgment	Billing everything to the client, even wasteful work or make-work
Billing empathy	Not describing work done for the client at all, or not describing it in a way that the client will understand what the lawyer did
Billing integrity/honesty	Putting the lawyer's own needs (to make a billable hour quota or to jockey for position within a firm) above the client's needs; misrepresenting work that's been done
Billing passion/engagement	Not paying attention to what's being done on a matter, and not scrutinizing the bill before sending it to the client
Billing diligence	Not recording time contemporaneously
Billing creativity	Adhering rigorously to the billable hours model, without instruction in how to bill time and without absorbing the costs of training associates

With these virtues—and vices—in mind, let's apply the virtues to create better billers.

V. VIRTUOUS BILLING APPLIED

A. Creating a System to Find—and Recognize—Red Flags

Ethical law firms want to build ethical habits. They do not want their lawyers billing phantom hours. One structural change that these law firms can institute is to have its bills (or, at least, its larger bills) subject to routine audit. Indeed, that is what some firms are doing. The auditors work for the law firm, not the client, so they can report the problem and give the firm an opportunity to correct it.

A law firm that institutes this change sends a message to every partner and associate: it is better for the law firm to catch the error (whether or not intentional) than for the law firm to react to a client's complaint. And it is better for the lawyer not to pad his hours because it will not look good if the law firm's auditors discover the padding.[143]

Although the truly virtuous biller will have developed those habits that result in accurate, ethical, understandable bills, we must assume that there will be

[143] Rotunda, *supra* note 1, at 720 (footnotes omitted).

those who have not yet developed such habits and those who are the classical bad actors.[144] The virtuous law firm will, as President Reagan once said, "[t]rust, but verify."[145] The many scandals that have occurred in organizations ranging from Enron[146] to General Motors[147] happened in part because the organizations' internal systems didn't check the right things and didn't pay attention to red flags. Law firms haven't escaped such scandals,[148] and they need to make sure that neither willful blindness to misconduct nor subconscious cognitive errors will keep them from discovering problems in billing behavior.[149]

B. Training the Billers

We've already discussed the importance of training people on how and what to bill.[150] Law firms probably understand how important training on billing is for every new employee, but understanding the need and providing effective training are two different things. As Susan Saab Fortney has explained,

> Neophyte attorneys forge into private practice with little or no experience in billing their time. Often associates start work with a "lecture" from a senior attorney who advises associates to "[b]ill every minute . . . we'll adjust the bill on the back end." This approach to billing does not recognize the traps involved in

---

[144] And we don't mean "bad actors" as in those actors that you see in straight-to-video flicks.

[145] The Conservative Will, *Trust But Verify*, YOUTUBE (MAR. 7, 2008), https://www.youtube.com/watch?v=As6y5eI01XE. Finding ways to verify can be fun (and amusing). In a recent article, Steven Levitt and Stephen Dubner explained why David Lee Roth's performance contract insisted that his dressing room have no brown M&Ms. People who read the contract carefully enough to realize that brown M&Ms were *verboten* and who were willing to sift through the M&Ms to pull out the brown ones would do a good job on the more important parts of his pre-concert set-up. Steven D. Levitt & Stephen J. Dubner, *Traponomics*, WALL ST. J., May 10, 2014, at C1. Thanks to Levitt and Dubner, now fledgling law review staffers will know why their Bluebooking and proofreading skills matter so much.

[146] *See, e.g.*, Jeffrey D. Van Niel & Nancy B. Rapoport, *Dr. Jekyll & Mr. Skilling: How Enron's Public Image Morphed from the Most Innovative Company in the* Fortune 500 *to the Most Notorious Company Ever*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 77 (Nancy B. Rapoport & Bala G. Dharan eds., 2004).

[147] *See* ANTON R. VALUKAS, REPORT TO BOARD OF DIRECTORS OF GENERAL MOTORS COMPANY REGARDING IGNITION SWITCH RECALLS (2014), *available at* http://www.detroitnews.com/article/20140605/SPECIAL01/140605001.

[148] *See, e.g.*, Lerman, *supra* note 98, at 848 (2006) (discussing the billing scandal central to the case of *In re* Romansky); *see also* Lattman, *supra* note 106; Pardau, *supra* note 91, at 6–7 (2013) (providing a laundry list of billing scandals at both big and small law firms).

[149]
> [C]onsider a firm that awards bonuses based on billable hours. If Associate *B* bills an average of 165 hours per month through September, but then bills 250 hours per month in the three remaining months of the year, thus reaching 2,235 hours and earning the $30,000 bonus the firm awards for 2,200 hours, are there reasonable grounds for suspicion? Perhaps *B* became involved in a large matter requiring an exceptional time commitment late in the year, or saw a dramatically increased workload for other legitimate reasons. It is also possible that *B* falsified time to earn a bonus to which *B* was not entitled. Either way, an alert firm leader tracking billable hours can determine whether there is cause for concern.

Richmond, *supra* note 2, at 111 (footnote omitted).

[150] *See supra* notes 122–25.

> billing another attorney's time. First, it assumes that the supervisor possesses enough information on the client's legal matter to evaluate intelligently the amount of time expended. Second, the approach assumes that the supervisor can ably sift through associate time sheets, which may be "propaganda piece[s]." Finally, if the firm compensates a billing partner for the amount collected from billed clients, the billing partner may be reluctant to write off associate time.
>
> Some senior attorneys may provide additional guidance on billing in instructing associates to "write down your time the same day, be honest, use good judgment, and don't double bill." This general advice gives associates unfettered discretion because the rules on billing practices remain unclear. Even when firm managers implement general billing guidelines, attorneys still have a great deal of latitude in the way that they apply the guidelines. This was illustrated by a management consultant who found a great deal of disparity in what firm partners would bill for travel, even though the firm implemented a policy to bill for travel time. Rather than leaving attorneys in a quandary on billing practices, firm managers can clarify how and what attorneys should bill. This guidance can include written guidelines, training programs and formalized channels within the firm for open communication.[151]

Training programs are necessary but by no means sufficient. The effect of social pressure (how other billers behave in the same firm) can counteract any official training program over time.[152] Not only is it important that the people at the top of the pecking order set the right tone,[153] but it is equally important that

---

[151] Fortney, *supra* note 96, at 252–53 (alterations in original) (footnotes omitted).

[152] *See* Rapoport, *supra* note 6, at 63–66 & nn.72–82 (describing Solomon Asch's experiments in social pressure and applying social pressure concepts to life inside a law firm).

[153]

> Another unintended consequence of quantifying law practice is that ethical attorneys who do not pad or do not work long hours may be placed at a competitive disadvantage come evaluation time. A couple of respondents referred to this problem. One respondent who described his or her diligence in using an electronic timer program to bill by the minute, expressed frustration over colleagues who estimate their time. The respondent stated, "I can't compete with estimators, but I'm not willing to compromise my strict billing practice either." In noting that the billable hours system "encourages lying," another respondent explained, "If you don't lie, you are perceived to be a slacker, even though, in reality, you may work far more than others." "Slacker" associates may feel pressure to change their practices or find other employment. Ethical associates who refuse to compromise their standards may become increasingly disillusioned in having to compete with other associates who use questionable billing practices to record hours. These ethical associates may voluntarily leave private practice.

Fortney, *supra* note 96, at 279; *see also id.* at 247–48 ("Even when firms deny the existence of a minimum or quota, associates learn about the firm's expectations or norms."). For another view of minimum requirements, cf. OFFICE SPACE (Twentieth Century Fox Film Corp. 1999), with quotes available at http://www.imdb.com/title/tt0151804/quotes:

> Stan, Chotchkie's Manager: We need to talk about your flair.
>
> Joanna: Really? I . . . I have fifteen pieces on. I, also . . .
>
> Stan, Chotchkie's Manager: Well, okay. Fifteen is the minimum, okay?
>
> Joanna: Okay.
>
> Stan, Chotchkie's Manager: Now, you know it's up to you whether or not you want to just do the bare minimum. Or . . . well, like Brian, for example, has thirty[-]seven pieces of flair, okay. And a terrific smile.
>
> Joanna: Okay. So you . . . you want me to wear more?
>
> Stan, Chotchkie's Manager: Look. Joanna.
>
> Joanna: Yeah.

a biller's peers behave appropriately. Solomon Asch's work teaches us that having as few as one or two people in a group diverge can cause others to go astray, even when they "know better."[154]

What kind of training would a virtuous law firm provide to its new employees? Dennis Curtis and Judith Resnik have some good ideas:

> [T]he seeming simplicity of an hourly billing system hides a series of questions—about which hours to bill, about the uses of billable hours, and about law firm structure and incentives. What is "work" that ought to be billed? Who judges how much of that work is necessary?
>
> Start first with deciding what counts as "work" for which time can be billed. Easy agreement emerges around the idea that lawyers can properly charge for legal work—research; writing memoranda for the purpose of giving advice; representing clients at negotiations, in court, and in administrative proceedings; lobbying or working on legislation and regulations; and perhaps in coordinating public relations or developing information from other professions about projects related to a client's interests. In terms of the quantity of such work, agreement between client and lawyer may in fact be more difficult to achieve, as clients may worry about lawyers who do more than is needed for a particular project.
>
> Assume for the moment that a packet of activity constitutes "the work" properly done by lawyers, as contrasted with para-professionals or nonprofessionals. How much of it needs to be done? What work is actually necessary? And who decides? Entailed are questions of delegation—about which workers ought to undertake which tasks and about which workers determine the contours of the task. Most of those who have explored these issues agree that the problem of measuring the quantity of such work that ought to be undertaken is significant. A widely shared perception is that the billable hour affects the lawyer's answer to that question. As William Ross explains,
>
>> [o]ne of the most egregious forms of overbilling in many law firms is the almost infinite amount of time that is expended upon research into even the most minute legal issues. As with other forms of overbilling, excessive research probably arises most often out of a genuine belief that the work serves the client's best interests, even if that belief is part of a subconscious rationalization of the desire to inflate the client's bill.[155]

Stan, Chotchkie's Manager: People can get a cheeseburger anywhere, okay? They come to Chotchkie's for the atmosphere and the attitude. Okay? That's what the flair's about. It's about fun.

Joanna: Yeah. Okay. So more[,] then, yeah?

Stan, Chotchkie's Manager: Look, we want you to express yourself, okay? Now if you feel that the bare minimum is enough, then okay. But some people choose to wear more and we encourage that, okay? You do want to express yourself, don't you?

Joanna: Yeah, yeah.

Stan, Chotchkie's Manager: Okay. Great. Great. That's all I ask.

[154] Solomon E. Asch, *Opinions and Social Pressure*, 193 SCI. AM. 31, 31–34 (1955); *see also* Rapoport, *supra* note 6, at 62–64 (discussing Asch's experiments).

[155] Curtis & Resnik, *supra* note 93, at 1413–14 (footnotes omitted); *see also* Lerman, *supra* note 98, at 888–89 (discussing how much lawyer discretion is involved in billing time). One of us has suggested the use of (or the development of) computer software that would help lawyers record their time contemporaneously. *See* Rapoport, *supra* note 6, at 85–87. Jennifer

One possible source of training that might combine client development with the development of useful habits is for a firm to invite inside counsel to the firm, on a regular basis, to engage in a conversation about things that inside counsel wish that their outside counsel would do differently.[156] A firm could bring in a panel of judges who rule regularly on issues like fee requests to talk about what does and doesn't pass muster. And a firm could bring in its insurance carrier to talk about common pitfalls. We know that good training is hard, and it's expensive, but the failure to train may end up costing a firm more in the long run.

C. The Tyranny of the 0.1 Hour Increment

As an aside, we can't resist pointing out that the decision on what the smallest billable increment in a firm should be creates some powerful (dis)incentives. The larger the minimum increment, the more likely it is that billers under pressure will fit tiny tasks into a vessel meant for bigger tasks. A thirty-second phone call shouldn't be billed as a quarter-hour (or tenth of an hour) of work, but that doesn't mean that someone won't try to do just that. On the other hand, the smaller the increment, the less meaningful it becomes when someone is exercising the virtue of billing diligence. If a lawyer bills in tenths of an hour and engages in multiple tasks each hour, is she really going to be willing to spend *more* than a tenth of an hour to record her time in those tenths, or will she just estimate, cross her fingers, and hope for a reasonably ethical result? It's difficult to maintain billing diligence on the busiest of days.

That's why training—and a more useful billing policy—is so important. Here's one option:

> Imagine, for example, a firm decision that no one could bill any client for less than ten minutes of time and that if amounts smaller than that were spent, no billable time would be logged. Imagine a rule that, as each lawyer departed for the day, that person had to leave a time sheet, and that no information logged later could be entered for that time period. Imagine that firms developed a system of team billing. The group of lawyers responsible for a given case might have projected caps on billing and no member of the group could enter hours without a more senior person agreeing that the time spent was necessary. Imagine a presumption against spending more than a certain number of hours a month, with a view that anyone logging over a specific amount had to meet with two senior members of the firm to explain the reality and propriety of excess hours. (Instead of minimum billable hours, imagine law practice with the conceit of maximum billable hours.) The practices of billing could shift from an individualistic activity to a cooperative event, with lawyers working on the same matter deciding together at the end of the day or week how many hours to bill.

Robbennolt and Jean Sternlight have pointed out that people tend to want to search for more and more information when making decisions. *See* JENNIFER K. ROBBENNOLT & JEAN R. STERNLIGHT, PSYCHOLOGY FOR LAWYERS 85 (2012).

[156] Or a law firm could invite the two of us to such a conversation, but we can't throw much business to the firm, and inside counsel can.

> Further, junior lawyers could be told that they lack the authority to determine the amount of time to record, and rather that the responsibility for allocating work and counting hours rested with the partners in charge. Such changes would require firms to work hard to allocate jobs among lawyers, but the benefit would be that the lawyers could concentrate on the substantive projects without worrying about whether the hours spent added sufficiently to their monthly total.[157]

Not only would a system like this one be more ethical, but it would also be more humane and more efficient.[158]

CONCLUSION

> *The moral fabric of an attorney is stitched out in the dozens—hundreds—of decisions that she makes each day. It is stitched out in the tone of voice she uses when talking with others, out of her choice of adjectives while writing a letter, out of the care she takes in describing what she represents to be the truth of a matter. It is stitched out of one decision after another, each of which may be mundane in itself, but all of which combine to form the moral fabric of the attorney, and combine with like decisions of other attorneys to form the moral fabric of law firms and legal communities.*
>
> *Not only are these decisions mundane, they are made almost instinctively. "Discernment is hard work; it takes time and emotional energy." Busy lawyers have neither. When an attorney is asked a question by a client or judge or when she sifts through documents that have been demanded by her opponent, or when she fills out her time sheet before rushing out of the office, she will have fractions of seconds to make decisions. She will have little time to think, much less to seek the counsel of colleagues or texts. She will act almost instinctively. What she does will not reflect the quality of her mind as much as it will reflect the quality of her character; it will not reflect discernment as much as it will reflect habit.*[159]

Developing the habits that create virtuous billers will create a chicken-and-egg problem, but that's not a bad thing. As our colleague Tigran Eldred has pointed out,

> if a law firm develops the types of virtuous billing practices you describe, would any improved ethical behavior be the result of more virtuous lawyers? Or would it be because the institutional incentives and norms create the type of influence

---

[157] Curtis & Resnik, *supra* note 93, at 1423–24.

[158] *See also* Alexandra Wolfe, *David Boies—The Lawyer on Overturning Proposition 8 and the Secret to His Legal Successes*, WALL ST. J., June 21, 2014, at C1 (describing David Boies's shift away from billing by the hour to fixed fees, on the grounds that hourly billing creates bad incentives and makes the workplace "less collegial").

[159] McGinniss, *supra* note 75, at 49 (quoting Patrick J. Schiltz, *Legal Ethics in Decline: The Elite Law Firm, the Elite Law School, and the Moral Formation of the Novice Attorney*, 82 MINN. L. REV. 705, 719–20 (1998)).

> toward conformity that you and others have so well documented in organizational settings?[160]

We don't know whether developing better habits will make people more virtuous only in the Aristotelian sense, or whether developing better habits will make people truly more ethical.[161] But we think that the effort is worthwhile.

One caveat, though: we wish that we could end on a wholly positive note, but we think that the classical lawyer virtues will continue to exceed our grasp so long as the problems that we've identified with multinational corporate law practices persist. Mind you, we're not suggesting that lawyers in multinational firms can't serve clients with technical excellence (they can, and they do) or that lawyers cannot behave ethically and morally (most do). And we know that some lawyers have found (or will find) ways to practice in a classically virtuous way. For as Bill Henderson has suggested, law firms outside the primary capital markets may well abandon the Cravath system and find ways to build solid (perhaps not solid gold) practices around like-minded lawyers, no longer in thrall to rainmakers and their omnipresent threats of departure. We have our doubts, because it takes a great deal of traction to pull away from institutions weighed down by money and tradition, but we're still hopeful.

---

[160] E-mail from Tigran Eldred, Professor, New England Law | Boston, to Nancy Rapoport (July 9, 2014) (on file with author Rapoport).

[161] And at least one of us doesn't care. When she teaches Professional Responsibility, she tells her students that she cares more about whether they behave as if they're ethical than if they actually are ethical. She believes that she can teach people how to behave as if they're ethical. *See supra* note 7; *cf. supra* note 41.

HOME