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DEVELOPMENTS OF NOTE

SEC Adopts Amendments to Money Market Fund Rules

The SEC announced that it has adopted amendments (the "Amendments") to its rules relating to money market funds, principally to Rule 2a-7 under the Investment Company Act of 1940, as amended. The Amendments were proposed in June 2009, as discussed in the July 7, 2009 *Alert*. The Amendments have not yet been published. The following description of the Amendments is based on the SEC's announcement regarding the Amendments and related statements prepared by the Staff of the SEC's Division of Investment Management.

Changes to Rule 2a-7's Risk-Limiting Conditions

The Amendments make several significant changes to the risk-limiting conditions in Rule 2a-7:

Maturity Calculations

- The Amendments decrease a money market fund portfolio's maximum permissible weighted average maturity from 90 days to 60 days; and

- A money market fund portfolio's weighted average maturity, determined without consideration to Rule 2a-7's maturity shortening provisions (what the Staff refers to as "weighted average maturity life"), may not exceed 120 days; this requirement is new.

Second Tier Securities

- The limit on a money market fund's holdings of "second tier" securities (generally, securities that have received short-term ratings in the second highest ratings categories,

or their equivalent) is decreased from 5 percent of total assets to 3 percent of total assets;

- The maximum amount a money market fund may hold in second tier securities of any one issuer is decreased from 1 percent of the fund's total assets to ½ of 1 percent of the fund's total assets; and

- The maximum permissible remaining maturity for a second tier security is reduced from 397 days to 45 days.

Minimum Liquidity Standard

- Each money market fund is subject to a new minimum liquidity requirement (there are none currently) under which it must maintain (a) at least 10 percent of its portfolio in cash, U.S. Treasuries and securities that convert to cash in one business day, and (b) at least 30 percent of its portfolio in cash, U.S. Treasuries, certain government securities with remaining maturities of 60 business days or less, and securities that convert to cash in one week; and

- The current 10 percent limit on illiquid securities articulated by the SEC staff is replaced by an express provision in Rule 2a-7 that prohibits a money market fund from purchasing any illiquid security if, after the purchase, more than 5 percent of the fund's portfolio consists of illiquid securities.

Changes on Treatment of Certain Types of Securities

The Amendments also make several important changes to the treatment of certain types of securities in which money market funds typically invest:

- *Ratings on Asset Backed Securities.* Money market funds will be permitted to invest in asset backed securities that are not rated by a Nationally Recognized Statistical Ratings Organization ("NRSRO"); currently, Rule 2a-7 requires funds to invest only asset backed securities that have received a rating from a NRSRO; and

- *Repurchase Agreements.* In order for a repurchase agreement to be fully collateralized, which, for diversification purposes, permits the fund to look through the repurchase agreement and treat the underlying collateral as the securities held by the fund, (a) the repurchase agreement must be collateralized only with cash and government securities (currently, a repurchase agreement may be deemed to be fully collateralized if it is collateralized with cash, government securities, securities rated in the highest rating category by the requisite number of NRSROs and unrated but comparable securities), and (b) the fund has evaluated the creditworthiness of the counterparty.

Operational and Disclosure Changes

The Amendments also add certain new operational and disclosure requirements:

- *"Know Your Customers."* In addition to complying with the new minimum liquidity standard, a money market fund will be required to hold securities that are sufficiently liquid to meet reasonably foreseeable redemptions. As a result, funds will be required

to adopt procedures to identify investors whose redemptions may pose a risk to the fund.

- *Stress Testing*. A money market fund's investment manager will be required to examine the fund's ability to maintain a stable net asset value in the event of market actions, large redemptions and other significant events.

- *NRSROs.* A money market fund's board must designate at least four NRSROs whose ratings the board deems reliable. The board is then entitled to disregard ratings from other NRSROs when determining that an investment meets Rule 2a-7's minimum ratings requirements.

- *Disclosure of Portfolio Holdings and Shadow Prices.* Each month, a money market fund must (a) disclose its portfolio holdings on its web site and (b) make a filing with the SEC (which will be publicly available) that reports (i) the "shadow price" of the fund's shares, which is calculated using the market prices of its portfolio securities rather than their amortized cost, and (ii) information relating to the fund's portfolio holdings.

- *Calculation of a Fund's Share Price at a Price Other than its Stable Net Asset Value.* A money market fund and its administrator must be able to process purchases and redemptions of fund shares at prices other than the fund's stable net asset value.

- *Certain Purchases of Portfolio Holdings by an Affiliate without SEC Approval.* Affiliates of a money market fund will have more flexibility to purchase distressed securities held by a money market fund without express SEC approval.

- *Suspension of Redemptions.* The board of a money market fund will be able to suspend redemptions of fund shares without express SEC approval and liquidate the fund if the board determines that the fund is about to "break the buck."

The *Alert* will provide more detailed coverage of this development once the SEC publishes the formal release describing the Amendments.

Basel Committee Issues Guidance Concerning Banks' Compensation Practices

The Basel Committee on Banking Supervision of the Bank for International Settlements (the "Basel Committee") issued guidance on "*Compensation Principles and Standards Assessment Methodology*" (the "Guidance"). The Guidance is designed to assist national financial supervisory agencies in assessing a bank's compensation practices. The Basel Committee said that the Guidance "will contribute to ongoing implementation of" nine "*Principles for Sound Compensation Practices*" (the "Principles") adopted by the Financial Stability Board (the predecessor of the Financial Statutory Forum (the "FSF")) that the Basel Committee believes are appropriate standards to use in implementing banks' compensation practices.

The Guidance covers all nine Principles, which are organized into three sections and address: (1) governance of compensation; (2) alignment of compensation with prudent risk taking; and (3) supervisory oversight of compensation practices and engagement by stakeholders. The Principles were proposed by the FSF as standards to reduce individuals' incentives to take excessive risks present in banks' compensation arrangements.

The Guidance recognizes that the Principles are designed to be internationally agreed upon objectives and high level principles with only a few specific benchmarks. The Basel Committee also acknowledges that the translation of the Principles and Guidance into national (rather than international) rules is key and that "in many countries, domestic rules represent the key reference point for supervisors, both in practice and in a legal sense." In addition, the Basel Committee stated that the Guidance is targeted at "significant financial institutions, particularly large, systematically important firms."

The assessment methodology provided in the Guidance has two major parts. The first part provides examples of criteria that could be used to assess whether a bank's compensation practices achieve the objectives of the applicable Principle. The second component – a supervisory review section – provides a toolkit that the Basel Committee said should be adapted to existing supervisory approaches and to the bank being examined. The Basel Committee further stated that the Guidance is "designed to help support a level playing field."

The nine Principles are set forth below and certain aspects of the related Guidance proposed by the Basel Committee are discussed following each set of Principles:

I. *Principles concerning effective governance of compensation*

PRINCIPLE 1: The firm's board of directors must actively oversee the compensation system's design and operation. The compensation system should not be primarily controlled by the chief executive officer and management team. Relevant board members and employees must have independence and expertise in risk management and compensation.

PRINCIPLE 2: The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended. The compensation system should include controls. The practical operation of the system should be regularly reviewed for compliance with design policies and procedures. Compensation outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions.

PRINCIPLE 3: Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm. Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation.

Principles 1, 2 and 3 focus on governance of compensation practices and the effectiveness of an independent financial and risk control function. The Guidance discusses the need for a compensation committee of the Board of Directors that exercises competent and independent judgment on compensation policies and practices, that works closely with a bank's risk management committee and/or risk management function and that ensures that compensation arrangements do not provide incentives for excessive risk taking. Among suggestions made are that personnel involved in controlling compensation risk management be themselves compensated at a level "sufficient to allow them to carry out their function effectively" and that the Board and/or the compensation committee be actively involved in performance reviews of these individuals.

II. *Principles concerning alignment of compensation with prudent risk taking*

PRINCIPLE 4: Compensation must be adjusted for all types of risk. Two employees who generate the same short-run profit but take different amounts of risk on behalf of their firm should not be treated the same by the compensation system. In general, both quantitative measures and human judgment should play a role in determining risk adjustments. Risk adjustments should account for all types of risk, including difficult-to-measure risks such as liquidity risk, reputation risk and cost of capital.

PRINCIPLE 5: Compensation outcomes must be symmetric with risk outcomes. Compensation systems should link the size of the bonus pool to the overall performance of the firm. Employees' incentive payments should be linked to the contribution of the individual and business to such performance. Bonuses should diminish or disappear in the event of poor firm, divisional or business unit performance.

PRINCIPLE 6: Compensation payout schedules must be sensitive to the time horizon of risks. Profits and losses of different activities of a financial firm are realized over different periods of time. Variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long periods. Management should question payouts for income that cannot be realized or whose likelihood of realization remains uncertain at the time of payout.

PRINCIPLE 7: The mix of cash, equity and other forms of compensation must be consistent with risk alignment. The mix will vary depending on the employee's position and role. The firm should be able to explain the rationale for its mix.

Principles 4 through 7 focus on compensation practices that reduce employees' incentives to take excessive risk. The Guidance suggests that in determining a business unit's variable compensation pool, the amount should be adjusted for all types of risk and notes specifically as elements to be considered: (a) the cost and quantity of capital required to support the risk of the business; (b) the liquidity risk assumed in the conduct of the business; and (c) consistency with the timing and likelihood of potential future revenues incorporated into current earnings. The Guidance provides that compensation payments should be deferred to permit clawback in the event of realization of risks during the deferral period. The Guidance suggests that firms have measures or strategies to treat "difficult-to-measure" risks, such as reputational risk, in their compensation practices. The Guidance further states that a low level of profits or losses at the firm-wide level should reduce or eliminate bonus pool payments and variable compensation to senior executives. Furthermore, the Basel Committee says that firms should have in place procedures or guidelines that explain the rationale for the percentage of cash, equity and other forms of compensation granted to an individual.

III. *Principles concerning supervisory oversight and engagement by stakeholders*

PRINCIPLE 8: Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action. Supervisors should include compensation practices in their risk assessment of firms, and firms should work constructively with supervisors to ensure their practices conform with the Principles. Regulations and supervisory practices will naturally differ across jurisdictions and potentially among authorities within a country. Nevertheless, all supervisors should strive for effective review and intervention. National authorities,

working through the FSF, will ensure even application across domestic financial institutions and jurisdictions

PRINCIPLE 9: Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders. Stakeholders need to be able to evaluate the quality of support for the firm's strategy and risk posture. Appropriate disclosure related to risk management and other control systems will enable a firm's counterparties to make informed decisions about their business relations with the firm. Supervisors should have access to all information they need to evaluate the conformance of practice to the Principles.

Principles 8 and 9 address supervisory review of compensation practices and transparency of disclosure of compensation practices. The Guidance urges that national supervisors should limit variable compensation as a percentage of total net revenue when it is inconsistent with the maintenance of sound capital levels. In addition, the Guidance provides that national supervisors should coordinate their efforts so that compensation standards are implemented consistently across jurisdictions. Furthermore, the Guidance suggests that disclosure of compensation practices should include, among other things, criteria used for performance measurement and risk adjustment, the linkage between pay and performance, deferral policy and vesting criteria, and the parameters used for allocating cash versus other forms of compensation.

The Principles of the Basel Committee's Guidance represent an international attempt to articulate best practices for compensation practices at large banks. These initiatives will continue both on a U.S. and international level and the *Alert* will continue to follow developments in this area.

Independent Directors Council Issues Report on Board Oversight of Sub-Advisers

The Independent Directors Council (the "IDC") issued a report designed to provide practical guidance to mutual fund directors on their oversight of fund sub-advisers. (The Mutual Fund Directors Forum issued a report on director oversight of sub-advisers which was discussed in the May 5, 2009 *Alert*). In preparing the report, the IDC assembled a task force of independent directors, in-house fund lawyers and compliance personnel experienced in working with sub-advisers. The report begins by summarizing several common arrangements involving sub-advisers and industry trends in the use of sub-advisers. The report continues by discussing the board's role in the selection of a sub-adviser, including the board's evaluation of the recommendation by the principal adviser relating to the engagement of a sub-adviser, related due diligence inquiries and assessment of whether the proposed sub-adviser will raise any director independence issues. The report highlights a number of considerations for a board in approving a sub-advisory agreement, including the structure of the sub-advisory agreement, the services to be performed under the sub-advisory agreement, the fee to be paid to a sub-adviser, potential conflicts of interest and sub-adviser profitability. The report also suggests that a board should assess the proposed integration of a sub-adviser in terms of operational functions, SEC reporting, portfolio management, valuation, proxy voting and soft dollar arrangements, among other matters. The report discusses a board's ongoing oversight role in areas such as portfolio management and performance, compliance programs, codes of ethics, affiliated transactions, litigation and related matters and changes in control. The report concludes by addressing the termination of a sub-advisory relationship, including issues related to operational impact. Appendices to the report provide a summary of trends in the use of

sub-advisers, a listing of terms commonly contained in sub-advisory agreements, a sample compliance certification and a sample compliance questionnaire.

OCC Approves First Use of "Shelf Charter" to Acquire a Failed Bank

The OCC approved the first use of a "shelf charter," a new mechanism that makes it easier for nonbank investors to buy failed banks without first owning a bank.

The shelf charter program, which was established by the OCC in November 2008, enables private equity firms to obtain conditional preliminary approval of a national bank shelf charter. The OCC stated that the approval process for a shelf process can be just as demanding as the approval process for a regular charter. During its initial review, the OCC evaluates "the qualifications of the proposed management team, the sources and amount of capital that would be available to the bank, and a streamlined business plan that describes how the acquired bank will be operated." If the OCC gives its conditional preliminary approval of the shelf charter, the shelf charter remains inactive until the private equity firm is ready to acquire a troubled banking institution. The private equity firm then must meet certain conditions specified in the OCC's conditional preliminary approval, be cleared to view the FDIC's list of troubled institutions and to bid for those institutions, and have its bid for such an institution approved by the FDIC. Since the beginning of the shelf charter program, the OCC has granted only four shelf charters, and prior to January 22, 2010, no shelf charter has been used to successfully bid for a failed bank.

On October 23, 2009, the OCC granted preliminary conditional approval to Roxbury Capital Group LLC's shelf charter for Bond Street Bank, National Association ("Bond Street Bank"), a subsidiary of Bond Street Holdings LLC ("Holdings LLC"). In the conditional approval, the OCC noted that Bond Street Bank must apply for Federal Reserve membership and obtain FDIC deposit insurance. The OCC granted its conditional approval even though Bond Street Bank "would not commence operations until after its bid for a particular institution is accepted by the FDIC," and conditioned its final approval upon its receipt of an acceptable Comprehensive Business Plan from Bond Street Bank, among other things.

On January 22, 2010, the OCC granted its final conditional approval, Approval #936, for Holdings LLC to establish Premier American Bank, National Association (the "Bank") for the purposes of acquiring the failed Premier American Bank, Miami, Florida from the FDIC in a purchase and assumption transaction, which was consummated on January 22, 2010. The final conditional approval was subject to various conditions to ensure the safe and sound operation of the Bank.

FinCEN Issues Report Showing Increase in Financial Institution SAR Reporting of Check Fraud and Other Types of Criminal Activity

The Financial Crimes Enforcement Network ("FinCEN") issued a report, *The SAR Activity Review*-Issue 13 (the "Review"), in which it stated that filings of suspicious activity reports ("SARs") during the first six months of 2009 for check fraud by all categories of financial institutions required to file SARs increased over the number of filings for check fraud during the same period in 2008. For example, the Review stated that depository institutions' SAR filings for check fraud increased 19% over the prior period and depository institutions' SARs for instances of suspected counterfeit checks increased by 36% over the comparable period. The Review noted, however, that depository institutions' SARs filed

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with respect to mortgage fraud increased only 1% over the first six months of 2008. Depository institution SAR filings reporting computer intrusion increased by 75% over the comparable six-month period in 2008. Furthermore, FinCEN reported that the total number of SARs filed by all reporting entities during the first six months of 2009 increased by 9% over the total number of SARs filed during the first six months of 2008. The Review provides additional SAR reporting data for securities firms and other types of financial institutions.