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DEVELOPMENTS OF NOTE

SEC Proposes Significant Revisions to Regulation AB and Other Rules Regarding Asset-Backed Securities

The SEC issued a [proposed rule](#) on April 7, 2010, that would have sweeping effects on the offering process and disclosure and reporting requirements for asset-backed securities (ABS). The recent financial crisis highlighted that investors and other participants in the securitization market "did not have the necessary tools" to be able to fully understand the risk and value of ABS, according to the SEC. In response, the SEC intends its proposals to offer comprehensive protections to investors, as well as to promote efficient capital formation. Major elements of the proposal are noted below. Comments on the proposed rule will be due 90 days following publication in the *Federal Register*.

Increased Disclosure and Reporting Requirements

Under the proposed rules, issuers would be required to disclose specific data relating to the terms, obligor characteristics, and underwriting for each loan or asset in the asset pool. Issuers would have to provide this information in a machine-readable, standardized format at the time of the securitization, when new assets are added to the pool and on an ongoing basis.

Furthermore, issuers would be required to file a “waterfall computer program” that would allow users to input information from the asset data file and evaluate the ABS.

Issuers would also be required to file a Form 8-K for a 1% or more change in any material pool characteristic from what is described in the prospectus, which would be a significant change from the current 8-K filing standard of a 5% change.

Changes to Shelf Registration Procedures for Asset-Backed Securities

The proposed rules would revise the filing deadlines in shelf offerings in order to require an issuer to file a preliminary prospectus at least five business days prior to the first sale in the offering.

Shelf eligibility for asset-backed securities would no longer be based on receiving an investment grade credit rating; instead, shelf eligibility would require the following:

- A certification by the registrant’s CEO that the assets in the pool have characteristics that provide a reasonable basis to believe that they will produce, taking into account internal credit enhancements, cash flows to service payments on the securities as described in the prospectus;
- The sponsor (or an affiliate of the sponsor) must retain a net economic interest (measured at issuance and then maintained on an ongoing basis) in each securitization by retaining at least 5% of the nominal amount of each of the tranches sold or transferred to investors, net of hedge positions directly related to the securities or exposures taken by such sponsor or affiliate (or in the case of revolving asset master trusts, 5% of the nominal amount of securitized exposures, net of hedge positions directly related to the securities or exposures taken);
- The pooling and servicing agreement (or another agreement) must contain provisions requiring the issuer to furnish periodic (and at least quarterly) third party opinions confirming that purchases or replacements of assets comply with the issuer’s representations and warranties in the agreement; and
- The issuer would be required to file Exchange Act reports with the SEC.

The SEC is proposing to create new Forms SP-1 and SF-3 for registered ABS offerings. Under the proposed rules, significant changes would be made to delayed shelf registrations under the new Form SF-3. Issuers would no longer file a base prospectus and prospectus supplements for shelf registrations and takedowns. Instead, the proposed rules would require issuers to file a single prospectus for each takedown including all of the information required by Regulation AB, which could potentially end the ability of issuers to incorporate information into takedown prospectus supplements by referring to a base prospectus.

Changes to Private Placement Safe Harbors

The proposed rules would give investors in private placements similar rights to information in public offerings of ABS. Under current Reg. AB and securities rules, issuers can avail themselves of the Rule 144A exemption for resales and other private placements and of the exemption for private offerings under Rule 506 of Regulation D. The SEC's proposed would require enhanced disclosure by ABS issuers who rely on these safe harbors by requiring the underlying transaction agreement for the securities to "grant to purchasers, holders of the securities (or prospective purchasers designated by the holder) the right to obtain from the issuer of such securities the information, upon request, that would be required if the transaction were registered under the Securities Act and such ongoing information as would be required under by Section 15(d) of the Exchange Act if the issuer were required to file reports under that section."

Furthermore, ABS issuers relying on the Rule 144A exemption would be required to (1) file a public notice on EDGAR of the initial placement of the structured finance products that are eligible for resale under Rule 144A; and (2) provide offering materials to the SEC upon written request.

Outstanding Asset-Backed Securities Not Subject to Proposed Rules

Importantly, the proposed rules would only apply to new issuances of asset-backed securities. Outstanding asset-backed securities would not be subject to the new regulatory regime.

HIRE Act Becomes Law: Revenue Offsets Aimed at Offshore Tax Evasion Have Extensive Reach

President Obama signed the [Hiring Incentives to Restore Employment Act](#) ("HIRE Act") into law on March 18, 2010. The HIRE Act, which is intended to facilitate the creation of jobs, provides a number of tax breaks, including a payroll tax holiday. Under the new legislation, private employers are generally exempted from the employer portion of social security taxes in relation to "qualified employees" for the period starting after March 18, 2010 and running through December 31, 2010. A qualified employee must start work anytime after February 3, 2010 and before January 1, 2011, and must have been unemployed for at least 60 days before his or her start date. The HIRE Act additionally provides a business credit for the retention of certain newly hired employees who remain employed for at least 52 consecutive weeks. Both provisions contain limitations that aim to prevent manipulation by employers.

To help pay for the tax incentives, the HIRE Act enacts a modified version of the previously proposed Foreign Account Tax Compliance Act of 2009 ("FATCA"). The cornerstone of FATCA is an enhanced reporting and withholding regime. As compared to the "qualified intermediary" ("QI") rules, FATCA reaches a wider spectrum of payments and institutions, and, for those institutions that are subject to both regimes, FATCA's requirements are in addition to the QI requirements. FATCA applies to "foreign financial institutions" ("FFIs"), which are broadly defined to include not only banks but also investment vehicles such as hedge funds. FATCA essentially puts an FFI to the choice of either (i) reporting annually to the Internal Revenue Service ("IRS") information about financial accounts that are held by certain US persons and US-owned foreign entities or (ii) being subject to a 30% withholding tax on "withholdable payments." The term "withholdable payment" includes

all US-source interest, dividends, rents, salaries, wages, annuities, and other similar items (commonly referred to as “FDAP”), as well as the gross proceeds from the sale or other disposition of property (such as stock and bonds) that can produce US-source interest or dividends (even if there is no gain on the disposition), provided, in each case, that such income is not already subject to US tax on account of its being attributable to the recipient’s conduct of a US trade or business. The FATCA reporting and withholding requirements apply only to payments made after December 31, 2012, and do not apply to payments made after 2012 on obligations in existence on March 18, 2012, or to the gross proceeds received after 2012 from the disposition of any such grandfathered obligation.

Some of the other significant changes in the in the HIRE Act include:

- Prospective repeal of the so-called “foreign targeted obligations” exception to the tax sanctions that apply to unregistered bearer bonds; this change, which applies to obligations issued after March 18, 2012, would, among other things, generally disqualify interest paid on foreign targeted bearer bonds from “portfolio interest” (and therefore exemption from withholding).
- Requiring taxpayers with more than \$50,000 in “specified foreign financial assets” (including accounts maintained at foreign financial institutions) to disclose such assets on their US tax returns for taxable years beginning after March 18, 2010, and imposing a penalty of up to \$50,000 for failure to report.
- Expanding the accuracy-related penalties to include underpayments attributable to undisclosed foreign financial assets for taxable years beginning after March 18, 2010, and imposing a penalty equal to 40% of the underpayment.
- Extending the statute of limitations to six years for understatements of income in which the excluded amount exceeds \$5,000 and is attributable to one or more reportable foreign assets; the extension is effective for all returns for which the statute of limitations did not expire as of March 18, 2010.
- Requiring a shareholder of a passive foreign investment company (“PFIC”) to file an annual report with the IRS; the effective date is March 18, 2010, but [Notice 2010-34](#) indicates that PFIC shareholders who were not already required to file an annual report will not be required to do so for taxable years that begin before March 18, 2010.
- Treating “dividend equivalent” payments made on or after September 14, 2010 as dividends from US sources for certain purposes, including withholding taxes on payments made to foreign persons; the scope of notional principal contracts subject to this rule expands on March 18, 2012.

Certain Noteworthy Tax Changes Resulting from the Health Care Reform Legislation

President Obama signed the [Patient Protection and Affordable Care Act](#) (“Patient Protection Act”) and the [Health Care and Education Reconciliation Act of 2010](#) (“Reconciliation Act”) into law on March 23, 2010 and March 30, 2010, respectively. The new legislation introduces revenue raisers that have far reaching tax planning implications, including additional Medicare taxes and codification of the economic substance doctrine.

Starting in 2013, the tax base for Medicare is broadened to include: (i) an additional tax of 0.9% on earned income in excess of \$200,000 for individuals and \$250,000 for married couples filing jointly, and (ii) a 3.8% “unearned Medicare contribution” tax equal to the lesser of 3.8% of “net investment income” or the excess of modified adjusted gross income over the threshold amount (\$250,000 in the case of a joint return, \$125,000 in the case of a married individual filing separately, and \$200,000 in any other case). These amounts are not indexed for inflation.

For transactions entered into after March 30, 2010, the Reconciliation Act codifies the judicial “economic substance doctrine.” As codified, the doctrine provides that transaction is treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Transactions that lack economic substance or fail to meet the requirements of any similar rule of law are subject to strict liability penalties of 20% or 40%, depending on the level of disclosure. In light of the steep penalties, the absence of a reasonable cause exception, and the vagueness of key language in the statute, this provision has generated substantial controversy.

US District Court Finds that Mutual Fund Violated Section 13(a) of 1940 Act by Failing to Secure Shareholder Approval of Amendment to Fund’s Industry Concentration Policy Effected Through Change in Status of Privately Issued Mortgage-Backed Securities as a Separate Industry

In a class action claim under California law brought by investors in a mutual fund (the “Fund”) against the Fund, the US District Court for the Northern District of California (the “Court”) granted a motion for summary judgment for the plaintiffs on the issue of whether the Fund violated Section 13(a) of the Investment Company Act of 1940 as amended (the “1940 Act”), by improperly changing its industry concentration policy of investing less than 25% in any industry so that the Fund could invest 25% or more of its assets in privately issued mortgage-backed securities. The plaintiffs claimed that they suffered losses in their Fund investments when there was a sustained decline in the value of privately issued mortgage-backed securities and that the Fund would not have sustained these losses had the Fund complied with its concentration policy prior to the change. The plaintiffs did not raise a claim under Section 13(a) directly, but rather did so indirectly through a claim under California’s unfair competition law, Cal. Bus. & Prof. Code 17200 et seq., asserting that defendants had engaged in unlawful business practices by violating federal law in the form of Section 13(a). The suit also includes claims under Sections 11, 12 and 15 of the Securities Act of 1933 against the Fund, the Fund’s adviser and related entities and the Fund’s officers and trustees; those claims were not addressed in this decision.

Concentration Policy. Section 13(a) prohibits a fund from changing its policy regarding concentration of its investments in a particular industry or group of industries without the approval of a majority of its shareholders. Form N-1A, which specifies the contents of a fund’s registration statements including its prospectus and statement of additional information (“SAI”), defines concentration to mean investing 25% or more of a fund’s assets in a particular industry or industries. In 2001, the Fund amended its registration statement to state that it would treat privately issued mortgage-backed securities as a stand-alone industry. In 2006, the Fund redefined privately issued mortgage-backed securities as no longer being part of any industry for purposes of the Fund’s concentration

policy. The statements regarding privately issued mortgage-backed securities appeared in a section of the SAI that indicated the descriptions it contained could be changed without shareholder approval unless otherwise noted. This section was separate from the section discussing limitations, including the Fund's concentration limitation, which stated that they could only be changed with shareholder approval. The plaintiffs alleged that the 2006 redefinition violated the Fund's concentration policy because it had not been approved by shareholders.

In ruling for the plaintiffs, the Court cited the text of the 1940 Act and its legislative history, including a study conducted by the SEC on the investment company industry prior to the Act's adoption that highlighted particular abuses by fund managers who violated stated policies of industry non-concentration, as standing for the broad proposition that a fund may not change its policy regarding industry concentration, either to concentrate or not to concentrate, without a shareholder vote. In addressing arguments that the definition appeared in a section that could be changed without shareholder vote, the Court stated:

The industry definition appeared under a long list of things that could be changed without shareholder vote "unless otherwise noted." Later in the SAI, of course, the concentration policy was "otherwise noted" as something requiring a shareholder vote to change. The industry definition was placed in a paragraph entitled "Concentration." It expressly referenced the fund's concentration policy. It even restated it. The industry definition would have been understood by reasonable investors to be an integral part of the concentration policy represented to be inviolate without shareholder approval. So the disclosure itself, read in the way reasonable investors would have understood it, disclosed the opposite of what the promoter now supposes.

The Court noted that neither the 1940 Act nor the SEC have defined "industry or group of industries" beyond a reference to standard industry classifications in one of the now withdrawn Guides to Form N-1A, and went on to observe "that a promoter is free to define an industry in any reasonable way when it establishes a fund and assumes for the sake of argument that the promoter may unilaterally, even after the fund is up and running, clarify in a reasonable way a definitional line that may otherwise be vague. But once the promoter has drawn a clear line and thereafter gathers in the savings of investors, the promoter must adhere to the stated limitation unless and until changed by a stockholder vote."

Implied Private Right of Action under Section 13(a). The Court's decision does not address the underlying issue of whether a private right of action exists under Section 13(a) despite the fact that Section 13 does not expressly provide for one. The vast majority of recent decisions have held that the only private right of action under the 1940 Act is under Section 36(b) for excessive compensation under an advisory contract. In March 2009 in a separate case involving a claim against a related fund defendant alleging that the fund had violated its concentration policy through investments in non-agency collateralized mortgage obligations, another judge in the Northern District of California found a private right of action implied in Section 13 (as discussed in the [March 10, 2009 Alert](#)) (the "March 2009 Decision"). In June 2009, the US Court of Appeals for the Ninth Circuit accepted the March 2009 Decision for interlocutory review.

US District Court Dismisses Closed-End Fund's Complaint Alleging That Investors Violated 1940 Act Anti-Pyramiding Limits

On March 5, 2010, a closed-end fund (the "Fund") filed a complaint against several privately offered funds and their control persons (the "Defendants"), including the individual control person who managed all the voting and investments decisions of the entity Defendants, in the US District Court for the District of Maryland (the "Court"). The complaint alleges that the Defendants acquired shares of the Fund in violation of the anti-pyramiding (Section 12(d)(1)(A)(i)) and anti-avoidance (Section 48(a)) provisions of the Investment Company Act of 1940. The anti-pyramiding provision prohibits any one investment company from owning, directly or through companies it controls, more than 3% of the voting securities of a registered investment company, such as the Fund. The anti-avoidance provision makes it unlawful for a person to do indirectly through another person or entity what would be unlawful to do directly.

The complaint alleges that the entity Defendants, under the direction of the individual Defendant, collectively accumulated more than 3% of the Fund's outstanding voting securities as part of a plan to exert improper, disproportionate undue influence over the Fund at its upcoming June 2010 shareholders' meeting. The Defendants allegedly use an activist arbitrage investment strategy targeting closed-end funds trading at a discount to their net asset value. In a Schedule 13D filing with the SEC, the Defendants disclosed that they had acquired more than 5% in the aggregate of the Fund's shares and wanted the Fund's management to take steps to eliminate or substantially reduce the Fund's discount to net asset value. If the Fund failed to do so, the Defendants threatened to use their voting power to, among other things, (a) seek board representation by nominating their own candidates (including the individual Defendants) for election to the Fund's board, (b) alter the Fund's capitalization, and (c) convert the Fund from a closed-end structure to an open-end structure. Alleging that the Fund and its investors would be irreparably harmed if the Defendants were allowed to carry out their plans, the Fund asked the Court for injunctive and declaratory relief.

On April 1, 2010, the District Court dismissed the Fund's complaint on the grounds that the Fund had failed to satisfy the threshold issue of whether a private cause of action exists under Sections 12(d)(1)(A)(i) and 48(a). In reaching its conclusion, the District Court was guided by the Supreme Court's decision in *Alexander v. Sandoval*, 532 US 275 (2001) ("*Sandoval*"), relating to judicially-implied private causes of action and by subsequent cases that applied *Sandoval*. The Court concluded that the Fund was not a member of the protected class of the anti-pyramiding provision because this provision was designed to protect individual investors, not investment companies, and that Section 12(d)(1)(A)(i) does not show evidence of a congressional intent to create a private remedy. In dicta addressing whether individual investors in the Fund might have a private right of action under Section 12(d)(1)(A)(i), the Court concluded that there was a "formidable presumption that no private cause of action exists under [Section] 12(d)(1)(A)." Separately, the Court concluded that the Fund had failed to state a claim under Section 48(a) because a claim under the anti-avoidance provision must be predicated upon a violation of some other provision of the 1940 Act, which the Fund had not successfully alleged. Accordingly, the Court dismissed the Fund's complaint.

Basel Committee Issues Updated Proposed Principles on Banks' Corporate Governance

The Basel Committee on Banking Supervision (the "Basel Committee") issued proposed, revised and updated principles (the "Proposed Principles") concerning sound corporate governance of banking organizations ("Banks" and each a "Bank"). The Basel Committee first published principles concerning sound corporate governance of Banks in 1999 and updated those principles in 2006. See the [February 28, 2006 Alert](#). The Proposed Principles, which are discussed in a paper entitled *Principles for Enhancing Corporate Governance*, reflect lessons learned during the recent financial crisis, which, said the Basel Committee, "highlighted the continued importance of sound corporate governance for [Banks]."

The Proposed Principles, among other things, address: (1) the role of the Board of Directors and its oversight of the Bank's risk management strategy; (2) the qualifications of members of the Board of Directors; (3) the importance of a well-developed and independent risk management function, including a chief risk officer who has the necessary stature and who is provided with the necessary authority, independence, resources and access to the Board of Directors to perform his or her job effectively; (4) the need to manage risk on an enterprise-wide basis and also on an individual-entity basis; (5) Board of Director oversight of compensation systems; and (6) the role played by bank regulators in evaluating Banks' corporate governance practices. The Proposed Principles also discuss the role of Bank senior management in corporate governance and transparent disclosure of Banks' corporate governance practices.

Comments on the Proposed Principles must be submitted to the Basel Committee by June 15, 2010.

SEC Staff Provides Guidance Regarding Collateralization Requirements for Repurchase Agreements Held by Certain Joint Accounts Used by Affiliated Investment Companies

The Staff of the SEC's Division of Investment Management (the "Staff") recently issued a letter (the "Guidance") stating that persons relying on the Staff's *Chase Manhattan* no-action letter (pub. avail. July 24, 2001) (the "Chase Letter") may continue to deem as "collateralized fully" repurchase agreements that are collateralized with securities rated in the highest ratings categories of certain nationally recognized statistical ratings organizations ("NRSROs"), or unrated securities of comparable quality, notwithstanding the recent amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the "1940 Act"). The Chase Letter, which permits affiliated registered investment companies to invest cash balances in joint accounts, includes a condition that if any asset in the joint account is used to acquire a repurchase agreement, the repurchase agreement must be "collateralized fully," as that term is defined in Rule 2a-7. The Staff issued the Guidance because the SEC's recently adopted amendments to Rule 2a-7 carve back the Rule's definition of "collateralized fully" to no longer include repurchase agreements that are collateralized with securities rated in the highest ratings categories of certain NRSROs, or unrated securities of comparable quality. The Chase Letter is discussed in the [July 31, 2001 Alert](#), and the recent amendments to Rule 2a-7 are discussed in the [March 5, 2010 Alert](#).

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OTHER ITEMS OF NOTE

FinCEN Issues Final Rule Amending BSA Definition of Financial Institution to Include Open End Mutual Funds

The Financial Crimes Enforcement Network (“FinCEN”) issued a final rule (the “Final Rule”) that will amend the definition of “financial institution” in FinCEN’s regulations, which is less inclusive than the definition in the Bank Secrecy Act itself, to include mutual funds. One consequence of the rule is that mutual funds will be subject to an obligation to report large currency transactions on currency transaction reports (“CTRs”) rather than Form 8300. The requirements for CTRs are somewhat different than the filing requirements for Form 8300; for example, “currency” for purposes of the CTR requirement includes only cash, while Form 8300 applies to transactions involving certain cash-like instruments, such as travelers’ checks and money orders. Another result of the rule amendment is that mutual funds will become subject to the so-called “Recordkeeping and Travel Rule,” which will require mutual funds to create and retain records and include certain information (such as the name and address of the transmitter, date and amount of the transmittal order, and identity of the recipient’s financial institution) in the transmittal order for wire transfers and other transmittals of funds in amounts of \$3,000 or more, subject to certain exceptions. The new reporting requirements will take effect 30 days after their publication in the *Federal Register*, while the recordkeeping requirements will only take effect 270 days after their publication in the *Federal Register*. A broader discussion of the Final Rule will appear in next week’s *Alert*.

Director of SEC Division of Investment Management Comments on Collective Investment Trusts, Additional Money Market Fund Regulations and the Division’s Review of Derivative Use by Funds

In a [speech](#) at a recent investment management industry conference, the Director of the SEC’s Division of Investment Management, Andrew J. Donohue, discussed aspects of the Division’s review of derivative use by registered funds and a second phase of money market fund rulemaking announced by the Commission. Mr. Donohue also indicated that the Division was looking into the manner in which the exception from the definition of investment company under the Investment Company Act of 1940 for collective investment trusts is being relied upon. He queried whether in certain instances “banks [are] operating merely in custodial or similar capacity while providing a place for an adviser to simply place pension plan assets of its clients” and suggested that the Division might make recommendations to the Commission in this area once the Division completes its review.

FDIC Board Approves Interim Rule Extending Transaction Account Guarantee Program to December 31, 2010

The FDIC Board of Directors approved today an interim rule (the “Interim Rule”) that would extend the Transaction Account Guarantee (“TAG”) Program from June 30, 2010 to December 31, 2010. The TAG Program provides customers of participating banks with full deposit insurance coverage on transaction accounts. The Interim Rule gives the FDIC Board of Directors the option to extend the TAG program until December 31, 2011 without further rulemaking. Banks that wish to opt out from the TAG program must do so by April 30, 2010. Comments on the Interim Rule are due to the FDIC within 30 days of its publication in the *Federal Register*.