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DEVELOPMENTS OF NOTE

SEC Staff Responds to Questions Concerning Recent Amendments to Money Market Fund Rules

The staff of the SEC's Division of Investment Management (the "Staff") recently responded to a number of questions concerning the recent amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the "1940 Act"), and other rules relating to money market funds. Those amendments were discussed in the [March 5, 2010 Alert](#). Below is a summary of the Staff's responses. (Capitalized terms not otherwise defined have the meaning given them in Rule 2a-7.)

Board Designation of NRSROs - Rule 2a-7(a)(11)(i)

- The board of directors of a money market fund that invests only in U.S. government securities or repurchase agreement fully collateralized with U.S. government securities does not need to designate nationally recognized statistical ratings organizations ("NRSROs"), as required by Rule 2a-7(a)(11)(i).
- A money market fund board does not have to designate four NRSROs for each type of security held by the money market fund, or designate at least one NRSRO for every type of security held by the money market fund.
- At the time a board designates an NRSRO, it must review whether, as a result of that designation, each portfolio security is an eligible security or if there has been a

downgrade. In other words, the designation of the NRSRO is treated as a credit event, and the fund must take whatever action is required as a result of that credit event.

- A money market fund' may disclose its designated NRSROs (and other investment policy changes made in response to the recent amendments) in a "sticker" to its registration statement filed pursuant to Rule 497 under the Securities Act of 1933, as amended, rather than an amendment filed pursuant to Rule 485(b) of that act.
- A money market fund's obligation to use designated NRSROs in determining whether a security is an eligible security commences when the fund first discloses its designated NRSROs in its statement of additional information.
- If an NRSRO that has previously been designated by a money market fund's board withdraws its registration as an NRSRO or is merged with another NRSRO, the board may designate a new NRSRO at any time before that event occurs or, if the withdrawal or merger is to occur shortly after it has been announced, at such time after the event has occurred as reasonably necessary to give the fund's adviser time to prepare a recommendation.

Maturity Requirement – Rule 2a-7(c)(2)

- A money market fund must be in compliance with the new weighted average maturity ("WAM") and weighted average maturity life ("WAML") limits by June 30, 2010. The Staff is not limiting the means by which a money market fund complies with those requirements (*i.e.*, a fund may choose to dispose of securities it holds or acquire additional securities to bring its portfolio into compliance).

Asset-Backed Securities

- In performing its minimal credit risk determination relating to an asset-backed security, a fund's board may disregard any of the minimal credit risk elements discussed in the adopting release if the board determines the element is not relevant to the security.

Liquidity Requirement – Rule 2a-7(c)(5)

- A money market fund may not rely on the maturity shortening provisions in Rule 2a-7(d) to determine whether a security is a "Daily Liquid Asset" or a "Weekly Liquid Asset," as defined in Rule 2a-7(a)(8) and Rule 2a-7(a)(32), respectively.
- A taxable feeder money market fund may not look to the holdings of the master fund for purposes of complying with the Daily Liquid Assets requirement. To comply, the master fund must guarantee redemptions in one day or the feeder must hold cash or other Daily Liquid Assets in amounts sufficient to satisfy the requirement. (Tax-exempt money market funds do not have to comply with the Daily Liquid Asset requirement.)
- A non-interest bearing U.S. government agency note (*i.e.*, an agency note issued at a discount, with principal paid at maturity) acquired by a money market fund at or above its face value and which matures within 60 days may qualify as a Weekly Liquid Asset.

- A money market fund may choose any reasonable time for determining its total assets, Daily Liquid Assets and Weekly Liquid Assets for purposes of complying with Rule 2a-7.
- A money market fund may treat as a Daily Liquid Asset a receivable from the sale of securities due the next business day, and as a Weekly Liquid Asset a receivable due within the next five business days, provided that the security is sold to a creditworthy buyer and the sale proceeds are due unconditionally the next day (Daily Liquid Asset) or within the next five business days (Weekly Liquid Assets). (Tax-exempt money market funds do not have to comply with the Daily Liquid Asset requirement.)

Stress Testing Requirement – Rule 2a-7(c)(11)(v)

- A money market fund that invests solely in direct obligations of the U.S. government does not have to perform stress tests for downgrades or defaults if the money market fund's fund board determines that the tests are not relevant and the money market fund keeps a record of that determination.
- A money market fund does not have to stress test its portfolio for the risk that the fund's share price determined using market prices would exceed \$1.005.
- Stress tests based upon "a down grade of or default on portfolio securities," as required by amended Rule 2a-7, should be designed to assist the board of the money market fund in assessing the effects of isolated stresses on the fund's shadow pricing, and the test should indicate the full extent of the loss the fund might be expected to incur as a result.
- A money market fund board may receive a single report at its next regularly scheduled meeting with the results of each stress test that occurred after its last regularly scheduled meeting.
- A money market fund should incorporate into its stress testing an evaluation of the liquidity needs of its shareholder base.

Website Requirement – Rule 2a-7(c)(12)

- A money market fund only offered to investment companies that are part of the same "group of investment companies," as such term is defined in Section 12(d)(1)(G)(ii) of the 1940 Act, must still comply with the website disclosure requirement.
- A money market fund must provide on its website a link to each of its Forms N-MFP filed during the previous twelve months, not just a link to the SEC's website or to the page on the SEC's website that allows a user to search for a company's filings.
- A feeder money market fund may disclose on its website the holdings of the master fund or provide a link to the master fund's website disclosure of its portfolio holdings.
- A money market fund is not required to post on its website a schedule of its investments for periods prior to September 30, 2010.
- A money market fund must provide its WAM and WAML calculations on the same webpage as its required list of securities.

Federal Reserve Bank of New York Releases White Paper on Tri-Party Repo Infrastructure Reform

The Federal Reserve Bank of New York (“FRBNY”) released a [white paper](#) (the “White Paper”) addressing policy concerns with weaknesses in the infrastructure of the tri-party repurchase agreement (“repo”) market. The White Paper includes the recommendations of the Tri-Party Repo Infrastructure Reform Task Force (the “Task Force”) created by the Payments Risk Committee, which is a private-sector group of senior U.S. bank officials that is sponsored by the FRBNY. The White Paper notes three significant policy concerns associated with the design of the tri-party repo market infrastructure: (1) the market’s reliance on large amounts of intraday credit made available to cash borrowers by the clearing banks that provide the operational infrastructure for these transactions, (2) the risk management practices of cash lenders and clearing banks, and (3) a lack of effective plans by market participants for managing the tri-party collateral of a large securities dealer in default without creating potentially destabilizing effects on the broader financial system.

RECOMMENDATIONS

In addressing these concerns, the Task Force identified the following areas for improvement: operational arrangements, dealer liquidity risk management, margining practices, contingency planning, and transparency. The Task Force’s recommendations include, among other things, “auto-substitution,” which will allow for the automated substitution of securities collateral supporting a tri-party repo transaction, while that transaction remains in place; adjustment by dealers of their liquidity risk management plans and liquidity buffers; statistical analysis by market participants and stress testing of collateral price movements; the development of “liquidation plans” for the management and liquidation of repo collateral in the event of a dealer default; and the use of a template developed by the Task Force for regular publication of key information provided by the clearing banks.

OTHER AREAS OF CONCERN

The FRBNY notes in the White Paper that the Task Force’s recommendations do not address all areas of concern. For example, the steps proposed to increase cash investors’ preparedness for the sudden failure of a large dealer do not directly address concerns that such failure could prompt the simultaneous liquidation of large amounts of assets and create fire-sale conditions. In addition, the FRBNY states that the recommendations will not materially alter the propensity of cash investors to run from a troubled dealer.

COMMENTS REQUESTED

Comments are requested by the FRBNY on the anticipated impact of the recommendations, implementation challenges, and additional steps that could be taken to strengthen the resiliency of the infrastructure supporting the tri-party repo market. The White Paper includes a list of questions to encourage meaningful discussion and thoughtful analysis of the issues. The FRBNY requested that comments be submitted by June 16, 2010.

SEC Rulemaking Initiatives Described in Unified Agenda of Federal Regulatory and Deregulatory Actions

The April 2010 [Unified Agenda of Federal Regulatory and Deregulatory Actions](#) (the “Agenda”), published by the Office of Management and Budget (the “OMB”), provides information on SEC rulemaking initiatives. Twice annually, all U.S. government agencies, including the SEC, must submit information on “all regulations under development or review,” which is compiled into the Agenda. (Separately, the SEC publishes in the *Federal Register* a subset of its submission to the OMB that reflects only those regulatory initiatives that are likely to have a significant economic impact on a substantial number of small entities.) The SEC is not precluded from considering or acting on initiatives that are not published in the Agenda, nor is the SEC required to act on matters that appear in the Agenda, or act on matters included in the Agenda in the indicated timeframes. The dates provided in the Agenda are probably not a very reliable indicator of when the SEC will act. Delays are not uncommon for the SEC, and the SEC’s rulemaking agenda is likely to be significantly affected by financial regulatory reform legislation currently under consideration. The Agenda may, nevertheless, give an indication of where SEC rulemaking priorities may lie. Described below are a number of rulemaking initiatives discussed in the Agenda that are likely to affect the investment management industry. The descriptions are divided into two categories - new initiatives and existing initiatives.

NEW INITIATIVES

Beneficial Ownership Reporting. The Division of Corporation Finance is considering recommending that the SEC propose revisions to Regulation 13D-G and Schedules 13D and 13G to modernize the beneficial ownership reporting requirements to, among other things, address the disclosure obligations relating to the use of equity swaps and other derivative instruments. The Division also is evaluating whether to recommend that the SEC propose rules to require public disclosure of significant short positions and short sales. The Agenda indicates that a rulemaking proposal is expected to be issued in September 2010.

Revisions to Regulation D. The Division of Corporation Finance is considering recommending that the SEC propose revisions to Regulation D, including, among other things, revisions to the accredited investor eligibility standards. (The SEC has already proposed amendments to Regulation D (August 2007) that among other things, would create a new category of “large accredited investor” and clarify the definition of “accredited investor” in light of developments since the term’s adoption, e.g., by adding alternative investments owned standards.) The Agenda indicates that a rulemaking proposal is expected to be issued in September 2010.

Books and Records To Be Maintained by Investment Advisers. The Division of Investment Management is considering recommending that the SEC propose amendments to update the books and records requirements for investment advisers. The SEC staff has for some time been indicating in public remarks that this initiative is under way. The Agenda indicates that a rulemaking proposal is expected to be issued in February 2011.

Frequency of Distribution of Capital Gains. The Division of Investment Management is considering recommending that the SEC propose amendments to rules governing dividend payments and distributions by registered investment companies under the 1940 Act, specifically Rule 19a-1. Rule 19a-1 prescribes the form of the written statement, required under section 19(a) of the Act, that discloses the sources of distribution payments when

distributions are made from any source other than income. This initiative has previously appeared in the Agenda. The Agenda indicates that a rulemaking proposal is expected to be issued in January 2011.

Fund of Funds Investments. The Division of Investment Management is considering recommending that the SEC propose (i) a new rule that would codify exemptive relief the SEC has granted permitting certain arrangements in which one investment company may invest in funds outside the same fund group and (ii) amendments to the exemptive rules under the 1940 Act that address the ability of one fund to invest in another fund. The Agenda indicates that a rulemaking proposal is expected to be issued in December 2010.

Investment Company Distribution Fees. The Division of Investment Management is considering recommending that the SEC propose amendments to Rule 12b-1 with regard to the use of fund assets in connection with the distribution of fund shares. This initiative has been mentioned frequently in public remarks by SEC Commissioners and Commission staff, albeit without any indication of the nature of any proposed amendments. The Agenda indicates that a rulemaking proposal is expected to be issued in June 2010.

Valuation of Portfolio Securities and Other Assets by Investment Companies. The Division of Investment Management is considering recommending that the SEC propose for comment interpretive guidance regarding the valuation of securities and other assets held by investment companies under the 1940 Act. The Agenda indicates that a rulemaking proposal is expected to be issued in December 2010.

Amendments to Form ADV, Part 1A. The Division of Investment Management is considering recommending that the SEC propose amendments to Part 1A of Form ADV to collect additional information from registered investment advisers to enhance the efficiency of the SEC's examination program. Part 1 of Form ADV is filed electronically and publicly available on the SEC website. The Agenda indicates that a rulemaking proposal is expected to be issued in December 2010.

Investment Adviser and Broker-Dealer Harmonization. The Division of Investment Management is considering recommending that the SEC propose rules designed to harmonize the investment adviser and broker-dealer regulatory regimes. The issue of investment adviser and broker-dealer regulation has been a topic of discussion regarding financial regulatory reform and in financial regulatory reform legislation. The SEC has had this issue under consideration since 2005 when it commissioned a report on investor understanding of the differences between investment advisers' and broker-dealers' financial products and services, duties and obligations from the Rand Corporation in connection with the SEC's adoption of rule amendments addressing the application of the Investment Advisers Act to broker-dealers offering certain types of brokerage programs (which rules were overturned by the Court of Appeals for the D.C. Circuit in 2007). The SEC published the Rand Corporation's report in January 2008 but has taken no formal action since in this area. The Agenda indicates that a rulemaking proposal is expected to be issued in March 2011.

Enhanced Disclosure for Separate Accounts Registered as Unit Investment Trusts and Offering Variable Annuities. The Division of Investment Management is considering recommending that the SEC propose rules designed to provide variable annuity investors with more user-friendly disclosure and to improve and streamline the delivery of information about variable annuities through increased use of the Internet and other

electronic means of delivery. The Agenda indicates that a rulemaking proposal is expected to be issued in December 2010.

Amendments to Rule 17a-5. The Division of Trading and Markets is considering recommending that the SEC propose amendments to Rule 17a-5 under the Securities Exchange Act of 1934 Act (the “1934 Act”) dealing with, among other things, broker-dealer custody of assets. The Agenda indicates that a rulemaking proposal is expected to be issued in June 2010.

EXISTING INITIATIVES

Indexed Annuities and Certain Other Insurance Contracts. The SEC is considering how to respond to the remand of Rule 151A under the Securities Act of 1933 by the U.S. Circuit Court of Appeals for the District of Columbia, which was discussed in the [July 28, 2009 Alert](#). The Agenda indicates that a rulemaking proposal is expected to be issued in May 2010.

Money Market Fund Reform. The SEC adopted amendments to Rule 2a-7 under the 1940 Act earlier in 2010 (as discussed in the [March 5, 2010 Alert](#)). In that rulemaking the SEC indicated that it would likely consider further reforms to its money market fund regulatory regime, which intention this Agenda item appears to reflect. Money market fund reform has featured in the Obama Administration’s recommendations for financial regulatory reform, but has not been an element of House or Senate legislation. The Agenda indicates that a rulemaking proposal is expected to be issued in October 2010.

Facilitating Shareholder Director Nominations. The SEC will consider taking final action on its proposal to amend proxy and related rules. The SEC proposed amendments to the proxy rules under the 1934 Act that would facilitate director nominations by shareholders. The proposed amendments would also modify Rule 14a-8 under the 1934 Act so that a company could not exclude from its proxy materials a shareholder proposal affecting the issuer’s nomination procedures or director nomination disclosure requirements. (For more detail on this proposal see the [May 26, 2009 Alert](#).) The Agenda indicates that final action on this initiative was expected to be taken in April 2010.

Amendments to Form ADV, Part 2. The SEC has proposed amendments to Part 2 of Form ADV, which dictates the information about a registered adviser’s services, personnel, business practices, fees and conflicts of interest that must be provided to new clients during the process of establishing an advisory relationship and must be made available to existing clients on an annual basis. The SEC’s proposal is designed to complete the overhaul of Form ADV that began in 2000. (Part 1 of Form ADV requests census type information from advisers that the SEC uses, in part, to inform its inspection process.) The SEC’s proposal would require Part 2 to be electronically filed (making it publicly available on the SEC website, as Part 1 is currently). The proposed amendments to Part 2 would replace Part 2’s check-the-box format with a list of disclosure requirements and would compel advisers to produce a narrative brochure in plain English to satisfy their brochure delivery obligations. The proposal would also revise Part 2’s disclosure, delivery and updating requirements. For a more detailed discussion of this proposal, see the [April 22, 2008 Alert](#). The Agenda indicates that final action on this initiative is expected to be taken in July 2010.

Guidance Regarding Fund Board Oversight of Investment Adviser Portfolio Trading Practices. In a 2008 release, the SEC proposed guidance for registered fund directors

regarding their oversight of fund portfolio transaction activity, including soft dollar use by fund advisers. The soft dollar portion of the release appears designed to fulfill commitments made by the SEC at the time it issued interpretive guidance on the safe harbor under Section 28(e) of the 1934 Act that it would also provide guidance to assist fund directors in overseeing adviser soft dollar use. For a more detailed discussion of the proposed guidance, see [August 5, 2008 Alert](#). The Agenda indicates that final action on this initiative was expected to be taken in December 2010.

Exchange Traded Funds. The SEC proposed new rules and rule amendments to provide exemptive relief for index-based and actively managed exchange traded funds (“ETFs”) (as discussed in the [April 1, 2008 Alert](#)). Further action on this proposal may be affected by the SEC staff’s deferral of requests from ETFs for exemptive relief that would allow them to make significant investments in derivatives pending completion of the staff’s review of derivatives use by investment companies including ETFs (as discussed in the [March 30, 2010 Alert](#)). The Agenda indicates that final action on this initiative is expected to be taken in December 2010.

Political Contributions by Certain Investment Advisers. The SEC proposed a new rule under the Investment Advisers Act of 1940 designed to address “pay to play” practices where an investment adviser makes political contributions or gifts to government officials in order to influence the selection of the investment adviser to manage money on behalf of state and local government entities (e.g., for public pension plans, retirement plans and 529 plans). For more detail on this proposal, see the [August 18, 2009 Alert](#). The Agenda indicates that final action on this initiative was expected to be taken in April 2010.

Investment Company Governance. The Division of Investment Management continues to consider what action if any to recommend regarding the two provisions in its corporate governance initiative for registered investment companies that were vacated by the Court of Appeals for the D.C. Circuit. The provisions in question would have required registered fund boards to be comprised of at least 75 percent independent directors and be chaired by an independent director. In June 2006 and December 2006, the SEC requested additional comment regarding these governance provisions. The SEC staff is reviewing the comments and determining what action to recommend. The Agenda does not indicate a date for further action on this initiative.

Confirmation and Point of Sale Disclosures. The SEC proposed new rules and rule amendments under the 1934 Act that would provide for additional confirmation and pre-transaction “point of sale” disclosure of distribution costs and conflicts of interest associated with transactions in mutual funds, variable life and annuity contracts, 529 Plan securities and unit investment trusts (as discussed in the [February 3, 2004 Alert](#)). The Agenda does not indicate a date for final action. Both the House and Senate financial regulatory reform bills expressly authorize, but do not direct, the SEC to adopt rules regarding the information to be received by retail investors prior to purchasing an investment product or service. The House bill also requires the SEC to conduct a study on this and other issues related to retail investors.

Nationally Recognized Statistical Rating Organizations. Beginning in 2008, the SEC began a rulemaking initiative designed to strengthen its oversight of credit rating agencies registered as Nationally Recognized Statistical Rating Organizations (“NRSROs”) and address issues such as the transparency of NRSRO methodologies, disclosure of ratings performance, and practices that create conflicts of interest. In conjunction with this

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initiative, the SEC has examined various rules and forms under the federal securities laws with an eye to eliminating references to credit ratings, and in some cases has determined that such references should be revised. The Agenda indicates that the SEC is recommending further action in this area, which is expected beginning in September 2010 and continuing through March 2011. Currently, the SEC has outstanding rulemaking proposals regarding its regulation of NRSROs that address, among other things, references to NRSROs in SEC rules and forms, disclosures regarding credit ratings and additional NRSRO reporting requirements. SEC rulemaking is likely to be significantly affected by financial regulatory reform legislation. Both the House and Senate bills address various facets of NRSRO regulation that would in many instances would be put into effect through SEC rulemaking.

SEC Staff Updates FAQ on Advisers Act Custody Rule to Address Additional Questions on Recent Rule Amendments

The staff of the SEC's Division of Investment Management (the "staff") updated its [FAQ](#) on Rule 206(4)-2 under the Advisers Act of 1940 (the "Custody Rule"). The Custody Rule imposes a number of requirements on SEC-registered investment advisers that are deemed to have custody of their clients' funds and securities. The staff updated the FAQ in March 2010 to address questions raised by the SEC's adoption of amendments to the Custody Rule and related rules (discussed in detail in the [January 5, 2010 Alert](#)), which generally became effective March 12, 2010. The new/revised questions in the May 2010 update address issues regarding whether or not custody exists under particular circumstances, *e.g.*, the posting of swap collateral, and how to comply with various aspects of the Custody Rule when a pooled investment vehicle does not fall within the exception that applies if it provides its investors with annual audited financial statements.

OTHER ITEM OF NOTE

FTC Further Postpones Compliance Date of Identity Theft Red Flags Rule Until December 31, 2010

The FTC [announced](#) that it has further delayed the compliance date for its Identity Theft Red Flags Rule (16 CFR 681) from June 1, 2010 until December 31, 2010, at the request of "Members of Congress," while Congress considers legislation that would affect the scope of entities covered by the Rule. As with prior compliance date delays for the Red Flags Rule, the FTC indicated that the postponement is limited to the Rule. The postponement does not affect other federal agencies' ongoing enforcement of corresponding identity theft program regulations.