

FINANCIAL SERVICES ALERT

Goodwin Procter LLP has one of the largest financial services practices in the United States.

SUBSCRIBE

CONTACT US

FSA BACK ISSUES

CONSUMER FINANCIAL SERVICES ALERT

OTHER PUBLICATIONS

EDITORS

[Eric R. Fischer](#)

[Jackson B.R. Galloway](#)

[Elizabeth Shea Fries](#)

Disclaimer:

This publication, which may be considered advertising under the ethical rules of certain jurisdictions, is provided with the understanding that it does not constitute the rendering of legal advice or other professional advice by Goodwin Procter LLP or its attorneys.

IRS Circular 230 Notice:

To ensure compliance with requirements under Treasury Department Circular 230, we inform you that the contents of this *Alert* are not intended or written to be used, and may not be used, for the purpose of (i) avoiding U.S. federal tax penalties or (ii) promoting, marketing or recommending to another party any matter addressed herein. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax adviser.

©2010 Goodwin Procter LLP
All rights reserved.

In this Issue:

Developments of Note

- ABA Task Force Submits Report on Investment Company Use of Derivatives and Leverage to SEC
- FDIC Board Approves Revisions to FDIC's MOU with Other Primary Federal Banking Agencies Concerning FDIC's Backup Supervision Authority
- Federal Court of Appeals Vacates SEC Rule on Indexed Annuity Contracts
- DOL Finalizes Amendment to QPAM Exemption
- Congress Clarifies that Section 13(c) of the Investment Company Act of 1940 Does Not Imply or Create a Private Right of Action under Section 13(a)

Other Items of Note

- Goodwin Procter Issues Client Alert on SEC Pay to Play Rule for Investment Advisers
- Comptroller of the Currency Dugan to Leave Office August 14, 2010

DEVELOPMENTS OF NOTE

ABA Task Force Submits Report on Investment Company Use of Derivatives and Leverage to SEC

Formed in April 2009 in response to a request from the Director of the SEC's Division of Investment Management, the Task Force on Investment Company Use of Derivatives and Leverage of the American Bar Association ("ABA") submitted a [report](#) to the Division that evaluates regulation and practice relating to the use of derivatives and leverage by registered investment companies ("funds") and makes recommendations on how the SEC and its staff can improve the regulatory framework in these areas. The report provides an overview of different kinds of derivatives used by funds and how the SEC has historically regulated funds' use of derivatives. The report identifies a number of issues that funds have had to address in the absence of SEC guidance and describes common industry practices that have arisen to address these issues. In addition to a general recommendation that regulation of derivative use by funds be principles-based, the report makes a number of specific recommendations, summarized as follows:

DIVERSIFICATION

For purposes of Section 5(b) of the Investment Company Act of 1940 (the "1940 Act"), which divides management investment companies (generally consisting of mutual funds and closed-end funds) into diversified and non-diversified funds, the report recommends

that a fund classify a derivative based on its reference asset, *i.e.*, the asset to which the derivative provides exposure, unless the reference asset is a broad-based index, or a commodity or currency.

CONCENTRATION

As with diversification, a fund's determination of the effect of a derivative holding on compliance with its industry concentration policy should be based on the derivative's reference asset.

FUND NAMES

As with diversification and concentration, a fund should be able to comply with the requirement under Rule 35d-1 of the 1940 Act that a fund ordinarily invest at least 80% of its assets in securities consistent with a name that suggests a type of investment or industry, by looking through to a derivative's reference asset.

COUNTERPARTY RISK

The SEC should regulate the counterparty risk associated with derivatives using the framework created by Section 12(d)(3) of the 1940 Act, which generally limits a fund's ability to invest in issuers in a securities-related business. Under the report's recommendations, Section 12(d)(3) based limits would also apply to counterparties that are not in a traditional securities-related business, and would be relaxed when a counterparty provides bankruptcy-remote collateral.

LEVERAGE AND ASSET COVERAGE

To address open issues and inconsistencies in SEC positions regarding the amount and type of assets that must be segregated to avoid a violation of the senior securities limitations of Section 18 of the 1940 Act, the report recommends that a fund using derivatives be required to develop policies that establish "Risk-Adjusted Segregated Amounts" ("RAS Amounts") for the different derivative instruments it uses based on their individual risk profiles. The determination of the amount to be segregated in each case would be based on consideration of factors such as the extent to which issuer or transaction-specific risk might result in a loss of the full notional amount of the derivative instrument or whether market practice and intra-day volatility suggest that the mark-to-market value of derivative is the more accurate measure of a fund's exposure. The report recommends that RAS Amounts also designate appropriate types of assets to be used to cover potential senior securities obligations created by derivatives and specify the types of transactions that may be used to offset derivative positions as an alternative to segregating assets. The report recommends that the SEC not treat as subject to Section 18 fund investments in securities that do not result in obligations beyond the investment amount, but provide potential investment exposure in excess of what would be achieved by investing in a corresponding conventional security. A fund should disclose its RAS Amounts in its statement of additional information.

DISCLOSURE

The report recommends that funds provide additional disclosure designed to offer insight into how derivatives have affected fund performance, and points to the description of fund performance provided by portfolio management in the shareholder letters accompanying

fund financial statements as an appropriate vehicle for this kind of disclosure, rather than the fund prospectus or statement of additional information.

BOARD OVERSIGHT

The report emphasizes that a fund's board should be viewed as acting in the same oversight role with respect to derivatives as it does with respect to any other fund activity. The report provides examples of specific actions typically undertaken by fund directors in their oversight role with respect to derivatives, such as approving the use of new types of derivative instruments. The report also discusses different types of reporting on derivatives use provided to fund boards. The report recommends that the SEC or its staff consider proposing guidance for public comment on the proper role of fund directors in overseeing derivatives and leverage.

FDIC Board Approves Revisions to FDIC's MOU with Other Primary Federal Banking Agencies Concerning FDIC's Backup Supervision Authority

The FDIC Board of Directors approved, by a vote of 5 to 0, revisions to its backup supervision and information sharing Memorandum of Understanding (the "Revised MOU") with the other primary federal banking regulatory agencies, the FRB, OCC and OTS (the "Banking Agencies"). The [Revised MOU](#) would enhance the FDIC's backup authorities over insured depository institutions ("IDIs") that the FDIC does not directly supervise. The FDIC stated that the Revised MOU will "improve the FDIC's ability to access information necessary to understand, evaluate and mitigate its exposure to [IDIs], especially the largest and most complex firms." The Revised MOU updates a 2002 accord among the Banking Agencies and clarifies and confirms the FDIC's authority and ability to assess risk at weakening IDIs and to prepare and implement effective strategies to resolve IDIs after they fail.

The Revised MOU broadens the list of covered IDIs to include: (1) Problem IDIs with a composite rating of "3," "4" or "5" or which are undercapitalized; (2) Heightened Insurance Risk IDIs where the FDIC's insurance pricing system suggests higher risk; (3) Large IDIs (including mandatory Basel II "Advanced Approach" financial institutions and IDI subsidiaries of a non-bank financial company or large interconnected bank holding company recommended by the Financial Stability Oversight Council for heightened prudential standards; and (4) IDIs that are affiliated with entities that have had greater than \$5 billion of borrowings under the FDIC's Temporary Liquidity Guarantee Program.

The Revised MOU also covers: (a) the scope of special examinations and FDIC on-site presence; (b) how the FDIC and the other Banking Agencies will coordinate activities, including, among other things, targeted reviews and sharing of information) and (c) how the Banking Agencies will address differences in CAMELS ratings.

Federal Court of Appeals Vacates SEC Rule on Indexed Annuity Contracts

The U.S. Court of Appeals for the District of Columbia Circuit (the "Court") issued an order vacating Rule 151A under the Securities Act of 1933 (the "1933 Act"). Rule 151A

was designed to require registration under the 1933 Act of certain indexed annuity contracts.

As discussed in more detail in the [July 28, 2009 Alert](#), the Court had previously ruled that the SEC failed to properly consider the effect of Rule 151A upon efficiency, competition and capital formation and therefore had remanded the matter to the SEC to address the shortcomings in its rulemaking. In response to a petition for rehearing, on June 12, 2010, the Court determined to vacate the rule rather than continue the remand to the SEC. In its order, the Court noted that the SEC has stated that it is likely to reissue the rule, but the SEC also acknowledged that it is in the midst of analyzing the effect of the rule upon the law of each state. The Court reasoned that the SEC cannot know whether that analysis will support reissuing Rule 151A until the analysis has been completed. The Court also stated that the decision to vacate would not be destructive of the agency's regulatory program because the rule has not gone into effect and, until such time as it does, the regulations supplied by state law will remain in place.

The Court did not address a related legislative development, which is the inclusion of the Harkin Amendment (Section 989G) in the conference report for the pending financial services reform legislation. The Harkin Amendment is designed to prevent the SEC from requiring registration of indexed annuities meeting certain state law requirements.

DOL Finalizes Amendment to QPAM Exemption

The Department of Labor (the "DOL") adopted a final amendment to prohibited transaction class exemption 84-14 (the "QPAM Exemption") under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The QPAM Exemption allows an ERISA plan to engage in transactions with "parties in interest" if, among other conditions, the assets are managed by a "qualified professional asset manager," or "QPAM," that is independent of the parties in interest and that meets certain other requirements. (See the [August 23, 2005 Alert](#) for information on the proposed amendment.)

The amendment to the QPAM Exemption permits a QPAM to manage assets of a plan sponsored by the QPAM or an affiliate of the QPAM. The amendment requires a QPAM that manages assets of its own plan (or a plan of an affiliate) to adopt written policies and procedures that are designed to assure compliance with the conditions of the QPAM Exemption, and to undergo an annual exemption audit by an independent person. The written policies and procedures and the annual exemption audit requirements are substantially similar to those required under Prohibited Transaction Class Exemption 96-23 (the "INHAM Exemption"). The final amendment to the QPAM Exemption adds additional clarifying language regarding certain aspects of the audit requirement that were not included in the proposed amendment. The amendment will become effective November 3, 2010.

Congress Clarifies that Section 13(c) of the Investment Company Act of 1940 Does Not Imply or Create a Private Right of Action under Section 13(a)

The recently enacted Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010 (the "Iran Sanctions Act") adds a rule of construction (the "Rule of Construction") to Section 13(c) of the Investment Company Act of 1940, as amended (the "Act"), that

PARTNERS AND COUNSEL

[Marco E. Adelfio](#)
[Lynne B. Barr](#)
[Raymond P. Boulanger](#)
[John J. Cleary](#)
[Daniel T. Condon](#)
[Margaret B. Crockett](#)
[James S. Dittmar](#)
[Anna E. Dodson](#)
[Alison V. Douglass](#)
[Eric R. Fischer](#)
[James O. Fleckner](#)
[Elizabeth Shea Fries](#)
[Lynda T. Galligan](#)
[Jackson B.R. Galloway](#)
[Stuart M. Glass](#)
[Mark Holland](#)
[John Hunt](#)
[James J. Kelly](#)
[Robert G. Kester](#)
[Robert M. Kurucz](#)
[Thomas J. LaFond](#)
[Paul W. Lee](#)
[William P. Mayer](#)
[Philip H. Newman](#)
[Christopher E. Palmer](#)
[Byron C. Pavano](#)
[Regina M. Pisa](#)
[Mark S. Raffman](#)
[Robert S. Seiqal](#)
[Brenda R. Sharton](#)
[Kevin L. Sheridan, Jr.](#)
[Derek N. Steingarten](#)
[William E. Stern](#)
[Marian A. Tse](#)
[Kimberly K. Vargo](#)
[Scott A. Webster](#)
[Michael P. Whalen](#)

clarifies that the text of Section 13(c) (which was added to the Act in 2007 in connection with earlier divestment legislation relating to Sudan) does not imply or create a private right of action under Section 13(a) of the Act, which prohibits a registered investment company (a “fund”) from changing its policies with respect to certain practices, including industry concentration, without shareholder approval, or any other provision of the Act. Section 13(c) prohibits any person from bringing an action against a registered investment company, or employee, officer, director or investment adviser to a registered investment company, based solely upon the investment company’s divestment from, or avoidance of investments in, securities of issuers determined to conduct or have direct investments in business operations in Sudan.

The Rule of Construction is designed to address a decision last year by a California federal district court finding a private right of action under Section 13(a) of the 1940 Act in a suit where shareholders alleged that a fund had violated Section 13(a) by improperly changing its concentration policy of investing no more than 25% in any industry so that the fund could invest more than 25% of its total assets in US agency and non-agency mortgage-backed securities. The judge in that case reasoned that if there were no private right of action under Section 13(a), Congress would not have needed to restrict the actions that could be filed under Section 13 by adding Section 13(c) (see the [March 10, 2009 Alert](#) for a detailed discussion of the 2009 decision).

OTHER ITEMS OF NOTE

Goodwin Procter Issues Client Alert on SEC Pay to Play Rule for Investment Advisers

A Goodwin Procter Client Alert discussing the SEC’s adoption of new Rule 206(4)-5 under the Investment Advisers Act and related rule changes that are designed to address certain “pay to play” practices is available [here](#).

Comptroller of the Currency Dugan to Leave Office August 14, 2010

After having served as head of the OCC for almost five years, Comptroller of the Currency, John C. Dugan, notified President Obama that he would leave office on August 14, 2010. President Obama is expected to nominate the next Comptroller in the near future.

Goodwin Procter LLP
Boston
Hong Kong
London
Los Angeles
New York
San Diego
San Francisco
Silicon Valley
Washington, D.C.