

FINANCIAL SERVICES ALERT

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DEVELOPMENTS OF NOTE

Proposed SEC Amendments to Rules Affecting Money Market Funds

As discussed in the [June 30, 2009 Alert](#), the SEC has proposed significant amendments to Rule 2a-7 under the Investment Company Act of 1940, as amended (the "1940 Act"). Rule 2a-7 sets forth the principal requirements applicable to registered investment companies operating as money market funds. The SEC also has proposed amendments to certain other rules, as well as two new rules, that if adopted, also will affect money market funds. This article summarizes the principal elements of the proposal reflected in the formal release, which is available at <http://sec.gov/rules/proposed/2009/ic-28807.pdf>.

Principal Changes to Rule 2a-7. Rule 2a-7 currently applies risk-limiting provisions to all money market funds in three areas: (a) the credit quality of the securities acquired, (b) the maturity of the securities acquired and the weighted average maturity of the portfolio as a whole, and (c) the diversification of the fund's holdings among non-governmental issuers, guarantors and providers of certain liquidity rights commonly referred to as "demand features." In addition, the SEC historically has interpreted Section 22(e) of the 1940 Act to restrict a money market fund from investing more than 10 percent of its assets in illiquid securities. (Section 22(e) generally requires that a registered investment company may not suspend redemptions, and it must pay shareholders their redemption proceeds within

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7 days.) The proposed amendments to Rule 2a-7 would make the following principal changes in each of these areas:

Quality Limitations

- Acquisitions of Second Tier Securities Prohibited. Under the proposed amendments, a money market fund would no longer be permitted to acquire “second tier securities,” that is, securities that at the time of acquisition have short-term ratings from the requisite nationally recognized statistical ratings organizations (“NRSROs”) in the second highest short-term ratings category, or unrated securities of comparable quality. In other words, a money market fund would only be able to purchase the highest quality securities, which currently are referred to as “first tier securities” under Rule 2a-7.
- Unrated Securities as Eligible Securities. Under the proposed amendments, if an unrated security had at the time of issuance a remaining maturity of more than 397 days, but a remaining maturity of 397 days or less and has received a long-term rating that is not within one of the two highest long-term rating categories, it may be an “eligible security” (that is, eligible for purchase by a money market fund) only if it has received a long-term rating from the requisite NRSROs in one of the two highest long-term rating categories. The current definition of an eligible security permits an unrated securities that has received a long-term rating that is not in one of the three highest long-term rating categories to be an eligible security only if it has received a long-term rating from the requisite NRSROs in one of the three highest long-term rating categories.
- Required Board Reassessments of Credit Quality. Under the proposed amendments, a money market fund’s board only would be required to reassess the credit quality of a security (that is, whether the security continues to present minimal credit risks) if, subsequent to the money market fund’s acquisition of an unrated security, the board becomes aware that the unrated security has received a rating from any NRSRO below its highest short-term rating category. Rule 2a-7 currently requires the board to reassess the credit quality of a security if, subsequent to acquisition, the security ceases to be a first tier security or the fund’s adviser becomes aware that an unrated security or a second tier security has received a rating from an NRSRO below the NRSRO’s second highest short-term rating category.

Maturity Limitations

- Reduced Weighted Average Maturity Limit. The proposed amendments would reduce the upper limit for the weighted average maturity of a money market’s portfolio from 90 days to 60 days.
- New Weighted Average Life Maturity Limit. The proposed amendments would introduce a “weighted average life maturity” limit of 120 days. Weighted average life maturity would be calculated without taking into account provisions of Rule 2a-7 that allow a fund holding’s maturity to be shortened when determining whether the weighted average maturity limit has been met. The practical effect of this limit would be to restrict a money market fund’s investments in long-term adjustable rate securities.

Diversification Limitations

- **Repurchase Agreement Deemed to be “Collateralized Fully.”** A money market fund may treat the acquisition of a repurchase agreement as the acquisition of the collateral underlying the repurchase agreement for purposes of Rule 2a-7’s diversification requirements, provided that the repurchase agreement is “collateralized fully,” as that term is defined in Rule 5b-3 under the 1940 Act. Under the proposed amendments, a repurchase agreement would be collateralized fully only if the collateral consists of cash items and/or government securities and the fund’s board has evaluated the creditworthiness of the seller of the repurchase agreement. Under Rule 2a-7 currently, a repurchase agreement may be collateralized fully if the collateral consists of securities that at the time the repurchase agreement is entered into are rated in the highest short-term ratings category by the requisite NRSROs or are unrated securities of comparable quality. Rule 2a-7 currently contains no express obligation to evaluate the creditworthiness of the repurchase agreement seller if the repurchase agreement is otherwise collateralized fully.

New Liquidity Limitation

- Under the proposed amendments, a new liquidity limitation based on a money market fund’s right to receive cash would replace the current 10 percent illiquid securities limitation, which is based on a fund’s ability to find a buyer for its holdings. Specifically, all money market funds would have to maintain daily and weekly liquid assets “sufficient to meet reasonably foreseeable shareholder redemptions” in light of the fund’s obligations under Section 22(e) of the 1940 Act and any commitment that the fund has made to its shareholders. In addition, under the proposed amendments:
 - **Board Determination-Retail/Institutional Fund.** A money market fund’s board would have to determine at least annually whether a fund should be designated as a “retail fund” or an “institutional fund,” that is, whether the money market fund is intended primarily for retail investors or institutional investors.
 - **Retail Fund Obligations.** A money market fund designated by its board as a “retail fund” would have to maintain: (a) a minimum of 5% of its total assets in cash, direct obligations of the U.S. government and securities that will mature or are subject to a demand feature that is exercisable and payable within one business day (but this requirement would not apply to tax exempt money market funds), and (b) a minimum of 15% of its total assets in cash, direct obligations of the U.S. government and securities that will mature or are subject to a demand feature that is exercisable and payable within five business days. These tests would have to be met each time the fund acquired a security.
 - **Institutional Fund Obligations.** A money market funds designated by its board as a “institutional fund” would have to maintain: (a) a minimum of 10% of its total assets in cash, direct obligations of the U.S. government and securities that will mature or are subject to a demand feature that is exercisable and payable within one business day (but this requirement

would not apply to tax exempt money market funds), and (b) a minimum of 30% of its total assets in cash, direct obligations of the U.S. government and securities that will mature or are subject to a demand feature that is exercisable and payable within five business days. These tests would have to be met each time the fund acquired a security.

- Identifying Investor Risk Characteristics. A money market fund would have to adopt policies and procedures pursuant to Rule 38a-1 under the 1940 Act (the rule that requires registered funds to adopt compliance programs) to insure that the fund is complying with its general obligations under Section 22(e) to assure that it has sufficient liquidity to meet the needs of its shareholders. Specifically, the policies and procedures would need to assure that the fund was taking appropriate efforts to determine the risk characteristics of the fund's shareholders, including those shareholders who hold fund shares through omnibus accounts, "portals" or other arrangements that provide the fund with little or no transparency with respect to the ultimate shareholder.

Other Proposed Changes to Rule 2a-7

The proposed amendments also include the following:

- Board Determination on the Fund's Capacity to Redeem Shares. A money market fund's board would have to determine at least annually that the fund or its transfer agent has the capacity to redeem and sell fund shares at a price per share calculated using market prices of fund assets, even if, for example, the use of market prices would result in a net asset value that differs from the stable net asset value the fund seeks to maintain;
- Notification to the SEC. A money market fund would have to notify the SEC if an affiliated person acquires any security from the fund in reliance on Rule 17a-9 under the 1940 Act (proposed amendments to Rule 17a-9 are discussed below). Currently, a money market fund must notify the SEC only if an event of default or event of insolvency occurs with respect to the issuer of a security, guarantee or demand feature that accounts for at least 0.5% of the fund's total assets.
- Stress Testing. A money market fund using the amortized cost method of valuation would have to adopt procedures for periodic testing of its ability to maintain a stable net asset value per share upon the occurrence of certain specified hypothetical events, including changes in interest rates, increases in shareholder redemptions, downgrades and defaults of portfolio securities, and the widening or narrowing of spreads between yields on appropriate benchmarks that the fund has selected for overnight interest rates and commercial paper and other types of instruments held by the fund. In addition, a money market fund would have to report the results of its testing to the board, and the fund's investment adviser would have to provide an assessment of the fund's ability to withstand the events that are reasonably likely to occur within the following year. The fund also would have to retain copies of its periodic test results and its adviser's assessments for at least 6 years, 2 years in an easily accessible place.

- **Public Disclosure.** A money market fund would have to report its portfolio holdings monthly to the SEC and post them on the fund's public website within 2 business days following month end.

Proposed Changes to Other Rules under the 1940 Act

The SEC's proposal includes two new rules under the 1940 Act and amends two existing 1940 Act rules (other than Rule 2a-7) as follows:

- **Transactions with Affiliates.** Proposed amendments to Rule 17a-9 under the 1940 Act would permit an affiliated person of a money market fund to purchase from the fund a security that remains an eligible security if the purchase price were paid in cash and were equal to the greater of the amortized cost or market price. In addition, if the affiliated person sold the security for a higher price, the affiliated person would have to pay the fund the difference between the sale price and the amount paid to the fund. Currently, Rule 17a-9 only permits affiliated persons from purchasing from a money market fund a security that no longer is an eligible security.
- **Redemptions.** Proposed Rule 22e-3 under the 1940 Act would exempt a money market fund from the requirements of Section 22(e) of the 1940 Act (as discussed above) if (a) the money market fund's market-based net asset value per share is less than its stable net asset value per share, (b) the fund's board, including a majority of its disinterested directors, has approved the liquidation of the fund, and (c) the fund, prior to suspending redemptions, notifies the SEC of its decision to suspend redemptions and liquidate its portfolio. The proposed rule also would, if adopted, exempt from the requirements of Section 22(e) a fund that has acquired shares of a money market fund pursuant to Section 12(d)(1)(E) of the 1940 Act (that is, the acquiring fund is a feeder fund in a master-feeder complex), provided that the acquiring/feeder fund also notifies the SEC that it has suspended redemptions. Proposed Rule 22e-3 is based in part on Temporary Rule 22e-3T under the 1940 Act (discussed in the [October 28, 2008 Alert](#)), which generally exempts a fund from the requirements of Section 22(e) if the fund is participating in the U.S. Treasury's Temporary Guarantee Program for Money Market Funds and is liquidating in accordance with the terms of that program.
- **Monthly Portfolio Reporting.** Proposed Rule 30b1-6 under the 1940 Act would require a money market fund to file within two business days after the end of each month a schedule of its investments on new Form N-MFP. To avoid duplicative reporting, the SEC has proposed related amendments to Rule 30b1-5 under the 1940 Act. Under amended Rule 30b1-5, a money market fund would be exempt from the requirement to provide a schedule of its investments in response in its reports on Form N-Q for its first and third quarters, but would still be subject to Form N-Q's controls/procedures and certification requirements.

Request for Comment on Measures Not Proposed. The SEC has not proposed, but is asking for comment on other possible charges to money market fund regulation, including, among others, the following:

- Investments in SIVs and Other Asset Backed Securities. Whether, and if so, how the SEC should amend Rule 2a-7 to address risks presented by structured investment vehicles (commonly known as SIVs) and asset backed securities;
- Reducing the Maximum Permitted Maturity Applicable to Non-Governmental Securities. Whether Rule 2a-7 should reduce the maximum permitted maturity for non-governmental securities from 397 days to 270 days;
- Public Disclosure of Shadow Prices. How investors in money market funds might react to the disclosure of market-based values for fund holdings (that is, the values assigned as part of the process of “shadow pricing” currently required under Rule 2a-7 as a means of testing the deviation of a money market fund’s net asset value based amortized cost from its net asset value based on market values) and related consequences for money market funds themselves;
- Elimination Amortized Cost Method of Valuation. Whether the ability to use the amortized cost method of valuation should be eliminated;
- Required In-Kind Redemptions. Whether money market funds should be required to satisfy redemption requests in excess of a certain size through in-kind redemptions.

Public Comment. Comments on the proposed amendments and proposed new rules are due by September 8, 2009.

Federal Banking Agencies and the National Credit Union Administration Seek Comments on Proposed Interagency Guidance on Funding and Liquidity Risk Management

The Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Credit Union Administration (collectively, “the Agencies”) in conjunction with the Conference of State Bank Supervisors (the “CSBS”), issued proposed *Interagency Guidance on Funding and Liquidity Risk Management* (“the Guidance”) and have requested comments on all aspects of the Guidance.

The Agencies and the CSBS have proposed the Guidance to provide consistent interagency expectations on sound practices for managing funding and liquidity risk. When finalized, the Guidance will apply to all domestic banks, savings associations, affiliated holding companies, and credit unions (collectively, “institutions”). In addition to summarizing principles of sound liquidity management that the Agencies have previously issued, the Guidance, where appropriate, aligns these principles with the Basel Committee on Banking Supervision’s guidance titled *Principles for Sound Liquidity Management and Supervision*.

The Guidance generally emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal well-developed

contingency funding plan as methods for monitoring and managing liquidity risk. “Liquidity risk” is defined by the Guidance as the risk that an institution’s financial condition or overall safety and soundness is adversely affected by an inability (or perceived inability) to meet its contractual obligations. The Guidance sets forth the following as critical elements of a sound liquidity risk management plan, and provides that supervisors will assess these elements when reviewing an institution’s liquidity risk management process, considering also the institution’s size, complexity, and scope of operations:

Corporate Governance. The board of directors and managers of an institution should take an active role in establishing, overseeing, and approving the institution’s comprehensive liquidity risk management plan. The Guidance also outlines the responsibilities of the board of directors and management with respect to the execution of the institution’s comprehensive liquidity risk management plan, including that the board of directors is ultimately responsible for the liquidity risk assumed by the institution.

Strategies, Policies, Procedures, and Risk Tolerances. Institutions should consider liquidity costs, benefits, and risks when engaging in the strategic planning and budgeting processes, and should also document strategies for managing liquidity risk, including strategies for managing different types of adverse business scenarios. The Guidance further provides that certain information should be included in an institution’s policies and procedures for managing and mitigating liquidity risk exposure, such as an articulation of the institution’s liquidity risk tolerance, the nature and frequency of management reporting, the potential courses of action for handling liquidity disruptions, and the liquidity issues that are unique to the institution’s individual currencies, legal entities and business lines. The policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections.

Liquidity Risk Measurement, Monitoring and Reporting. The Guidance calls for institutions to employ comprehensive methods of measuring and monitoring liquidity risk, which should incorporate: cash flow projections that rely on reasonable, appropriate, and documented assumptions; proper valuation of assets that consider market conditions potentially lowering such valuations; assessments of vulnerabilities to changing liquidity needs and capacities; regular stress testing and the evaluation of stress test results; the calculation of available and pledged collateral; and the monitoring and control of the institution’s liquidity risk exposures and funding needs within and across legal entities and business lines, considering legal, regulatory, and operational limits on the transferability of liquidity. Additionally, liquidity risk reports should provide the institution’s management with detailed information that enables the management to assess the institution’s sensitivity to changes in market conditions, its own financial performance, and other important risk factors. Such reports may contain information regarding cash flow gaps and projections, critical assumptions used in projections, asset and funding concentrations and availability, collateral usage, key risk indicators, the status of contingent funding sources, and the availability and utilization of government support.

Intraday Liquidity Position Management. The Guidance notes that interdependencies that exist among payment systems and the inability to meet certain critical payments may cause systemic disruptions to payment systems and money markets; therefore, senior management of institutions that engage in significant payment, settlement and clearing activities should adopt an intraday liquidity strategy as a component of the institution’s liquidity risk management process. The Guidance provides that the intraday liquidity strategy should allow the institution to: monitor and measure expected daily gross liquidity inflows and

outflows; utilize collateral to obtain intraday credit; identify and prioritize obligations; control credit to customers; and consider collateral and liquidity obligations when assessing the institution's overall liquidity needs.

Diversified Funding. Noting that undue reliance on any one source of funding is considered an unsafe and unsound practice, the Guidance also provides that institutions should diversify available and potential sources of funding. Among other diversification strategies, institutions should consider secured and unsecured market funding, securitization vehicles, geographic markets, access to capital markets and the identification of funding sources that would strengthen the institution's capacity to withstand both institution-specific and market-wide liquidity shocks.

Cushion of Liquid Assets. Institutions should have ready access to unencumbered, highly liquid assets because liquid assets are critical to an institution's ability to effectively respond to potential liquidity stress. Stress testing and the institution's risk profile and tolerance should support the amount of liquid assets available to the institution.

Contingency Funding Plan. Institutions should have a formal and regularly tested contingency funding plan that sets forth the institution's strategies for addressing liquidity shortfalls in emergency situations and in the event that the institution becomes subject to Prompt Corrective Action. The contingency funding plan should: identify stress events; delineate between levels of stress severity; equip the institution's management to accurately assess and quantify the institution's expected funding needs and capacity during stress events; identify potential funding sources that would be readily available when needed; and establish a monitoring framework for potential liquidity stress events that enables the institution to strategically prepare for depletion of the institution's liquidity. The Guidance notes that institutions should not base their liquidity strategies on temporary government programs.

Internal Controls. The Guidance provides that institutions should maintain internal controls and audit procedures relating to liquidity risk in accordance with board-approved policies and applicable rules and regulations. The institution's management should ensure that an independent party regularly reviews and evaluates the various components of the institution's liquidity risk management process, and that the independent party reports significant issues to the appropriate level of management.

Liquidity Risk Management at the Holding Company Level. Underscoring that liquidity difficulties at the holding company level may spread to subsidiary companies, the Guidance also provides that financial holding companies, bank holding companies, and savings and loan holding companies (collectively, "holding companies") should develop and maintain liquidity management processes and funding programs. Therefore, holding company liquidity should be maintained at levels sufficient to fund its operations and the operations of affiliates for an extended period of time, subject to legal, regulatory, and practical restraints. The Guidance notes that the Federal Reserve's Trading and Capital Markets Activities Manual and Bank Holding Company Supervision Manual and the Office of Thrift Supervision's Holding Company's Handbook provides further guidance regarding the principles of safe and sound liquidity risk management of holding companies.

Comments on the Guidance must be submitted on or before September 4, 2009. The Guidance is available at <http://www.fdic.gov/news/news/financial/2009/fi09037.html>.

SEC Proposes Corporate Governance – Related Proxy Rule Amendments and Approves NYSE Rule Amendment Affecting Broker Discretionary Voting for Elections

At its open meeting last week, the SEC voted to propose amendments to the proxy rules under the Securities Exchange Act of 1934, as amended, that would (a) give effect to requirements that public companies receiving money from the Troubled Asset Relief Program (“TARP”) provide a shareholder vote on executive pay in their proxy solicitation relating to annual elections of directors, (b) require additional disclosure in the proxy materials of public companies regarding compensation and governance matters and (c) make other miscellaneous changes such as requiring faster reporting of election results. The SEC also approved a New York Stock Exchange (“NYSE”) rule change to prohibit brokers from voting a customer’s proxy in director elections for issuers other than registered investment companies without instructions from the customer.

The formal release proposing proxy rule amendments requiring shareholder approval of executive compensation for recipients of TARP assistance is available at <http://www.sec.gov/rules/proposed/2009/34-60218.pdf>. The SEC has not issued a formal release for the other proposed proxy rule amendments. The SEC will issue an approval order for the NYSE rule change, which also codifies two previously published interpretations that do not permit broker discretionary voting for material amendments to investment advisory contracts with an investment company (see the [March 10, 2009 Alert](#) for a discussion of these amendments as proposed). The NYSE rule changes will apply to shareholder meetings held on or after January 1, 2010.

OTHER ITEMS OF NOTE

Goodwin Procter’s Financial Services and Private Equity Groups Issue Jointly Prepared Alerts on FDIC’s Proposed Policy Statement On Private Equity Investments in Failed Banks or Thrifts

Goodwin’s Financial Services and Private Equity Groups issued jointly prepared alerts on the FDIC’s recent proposed policy establishing standards for bidder eligibility in connection with the resolution of failed insured depository institutions. The *Alert* will continue to follow developments in this area.

Financial Services Alert - Special Edition

<http://www.goodwinprocter.com/~media/66BF95F308894DB6B8B494E551B50F9B.ashx>

Private Equity Update

<http://www.goodwinprocter.com/~media/552A23A9754B400C80E98CF3B973CEE9.ashx>

Goodwin Procter Issues Public Company Advisory on SEC’s Proposed Proxy Rule Amendments Affecting Shareholder Nomination of Directors

Supplementing an article in the [June 16, 2009 Alert](#), Goodwin Procter has issued a Public Company Advisory discussing proposed proxy rule amendments that would (a) allow shareholders that meet certain conditions to nominate directors for election using a company’s proxy materials (*i.e.*, the company would have to include the shareholder

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nominee in its proxy statement and proxy card) and (b) generally require a company to include in its proxy materials a shareholder proposal that would amend or request an amendment to the company's governing documents regarding nomination procedures or disclosures related to shareholder nominations. View the Public Company Advisory at <http://www.goodwinprocter.com/~media/9729699F997D4DC5B680F8218380D9F9.ashx>.

FINRA Publishes Red Flags Rule Identity Theft Prevention Program Template

FINRA has provided its members with a template for an identity theft prevention program designed to comply with the FTC's red flags rule (16 CFR 681.2). (The FTC red flags rule's compliance date is August 1, 2009). The template is an optional guide that can be customized to produce an identity theft prevention program tailored to a FINRA member's particular circumstances. Following the template does not guarantee compliance with the red flags rule or offer a safe harbor. The FINRA template is available at <http://www.finra.org/Industry/Issues/CustomerInformationProtection/p118480>.

CFTC Seeks Comment on Intention to Collect Ownership and Control Information for Futures Accounts

The CFTC announced its intention to collect certain ownership and control information for all trading accounts active on U.S. futures exchanges. The information will be collected via an account ownership and control report ("OCR") submitted periodically to the Commission by designated contract markets and potentially other reporting entities. OCR data will include trading account numbers, the names and addresses of accounts' owners and controllers, and the last four digits of owners' and controllers' social security or tax identification numbers. The CFTC believes that the collection of OCR data will enhance market transparency, leverage existing surveillance systems, and foster synergies between the Commission's regulatory, enforcement, and economic research programs. The CFTC is seeking public comment to help implement the OCR. Comments must be submitted no later than August 17, 2009.