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Treasury Financial Regulatory Reform Program – Proposed Legislation Regulating the OTC Derivatives Markets

On August 11, 2009, the Treasury Department [unveiled proposed legislation](#) regulating the over-the-counter derivatives market, the [“Over-the-Counter Derivatives Markets Act of 2009” \(the “Proposed Act”\)](#). The Proposed Act is based on reforms outlined in the Treasury’s white paper on financial regulatory reform (the “White Paper”) issued in June 2009 (as discussed in the [June 23, 2009 Alert](#)). The Proposed Act is lengthy and, as promised in the White Paper, contemplates wide-ranging changes to the over-the-counter derivatives market, while falling shy of more radical reforms such as an outright prohibition on credit default swaps (“CDS”). A separate Goodwin Procter Client Alert detailing the proposed legislation will be issued later this week.

DEVELOPMENTS OF NOTE

Proposed SEC Rule Addresses “Pay to Play” Practices by Investment Advisers Seeking to Manage Money on Behalf of State and Local Governments

The SEC proposed a new rule under the Investment Advisers Act of 1940 (the “Advisers Act”) 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). This article summarizes the principal elements of the proposed rule reflected in the [formal release](#).

Background. In 1999, the SEC proposed a rule designed to address pay to play issues for investment advisers, but took no final action. In the interim, the SEC and state authorities have brought high profile cases and reached settlements regarding alleged pay to play arrangements. The proposed rule is modeled on MSRB Rules G-37 and G-38, which were adopted to address pay to play practices for broker-dealers and municipal securities dealers in the municipal securities markets, and on the SEC’s 1999 rule proposal.

Two Year Compensation Timeout. The proposed rule applies to any investment adviser registered with the SEC and any investment adviser that has not registered with the SEC in reliance on the exemption available under Section 203(b)(3) of the Advisers Act, which is available to advisers that do not hold themselves out to the public as investment advisers and who have fewer than 15 clients (such advisers along with registered advisers being referred to collectively as “Advisers”). The proposed rule would prohibit an Adviser from receiving compensation for providing advisory services to a state or local government entity (including to plans or pools of assets established by the government entity or to the government entity’s officers or employees in their capacities as such) for a two-year period after the Adviser or any of its covered associates makes a political contribution to an official of that government entity with authority to directly or indirectly influence the award of advisory business.

- An “official” under the proposed rule includes an incumbent, candidate or successful candidate for elective office.
- A “contribution” would include any gift, subscription, loan, advance or deposit of money or anything of value made for (i) the purpose of influencing any election for federal, state or local office; (ii) payment of debt incurred in connection with any such election; or (iii) transition or inaugural expenses of the successful candidate for state or local office. (The proposed rule includes a *de minimis* exception for aggregate contributions of \$250 per election by an individual entitled to vote in the election and a very limited exception for certain returned contributions.)
- A “covered associate” of an Adviser means any (i) general partner, managing member or executive officer, or other individual with a similar status or function; (ii) employee who solicits a government entity to be an advisory client of the Adviser; or (iii) political action committee controlled by the Adviser or by a person in either of the foregoing categories.

Under this two-year “time out” provision, an Adviser that had made contributions subject to the rule would not be prohibited from providing advisory services to the government client in question, but would instead be prohibited from *receiving compensation* for providing advisory services to the government client, which could entail providing advisory services *gratis* for a reasonable time until a successor adviser could be appointed. The proposed rule also includes a “look-back” element that would attribute contributions made by a covered associate of an Adviser to other Advisers that employ that person within two years after the date of the contribution. Thus, an Adviser would be required to implement policies and procedures designed to, among other things, determine whether it would be subject to any restrictions under the proposed rule as a consequence of engaging any particular covered associate.

Prohibition on Payments to Third Parties to Solicit Government Advisory Clients. The proposed rule would prohibit an Adviser from paying third parties (*e.g.*, solicitors, finders, placement agents or pension consultants) to solicit a state or local government entity as an advisory client. This broad ban would be subject to a narrow exception for solicitations on behalf of an Adviser by control affiliates of the Adviser (or their employees) or any of the Adviser’s employees, general partners, managing members or executive officers.

Ban on Soliciting and Coordinating Contributions and Payments. The proposed rule would prohibit an Adviser and its covered associates from soliciting any person or political action committee to make, or from coordinating, any contribution to an official (or candidate for office) of a government entity to which the Adviser is providing (or is seeking to provide) investment advisory services, and from soliciting payments to a political party of the state or locality where the Adviser is providing (or is seeking to provide) investment advisory services to a government entity. This element of the proposed rule is intended to prevent an Adviser from circumventing the proposed rule by making payments to political parties, or by making or coordinating contributions through a third party “gatekeeper,” in order to influence the investment adviser selection process.

Application of the Proposed Rule to Certain Pooled Investment Vehicles. The proposed rule treats an Adviser that manages certain types of pooled investment vehicles, referred to as “covered investment pools,” in which a government entity invests or is solicited to invest in the same manner as if the Adviser were providing (or seeking to provide) investment advisory services directly to the government entity. Under the proposed rule, a “covered investment pool” is any (i) investment company as defined in Section 3(a) of the Investment Company Act of 1940, as amended (the “1940 Act”) or (ii) company excluded from the definition of “investment company” under Sections 3(c)(1), 3(c)(7) or 3(c)(11) of the 1940 Act. A narrow exception would exist for an Adviser to a registered investment company whose shares are registered under the Securities Act of 1933. Under these circumstances, the two-year “time-out” provision (triggered by contributions to a public official by the Adviser or any of its covered associates) would only apply when the registered investment company is an investment or an investment option of a plan or program of a government entity (*e.g.*, a 529 plan). (The proposed rule’s other prohibitions and limitations would still apply to the Adviser and its covered associates with respect to the registered investment company.)

Other Indirect Contributions or Solicitations. Similar to Section 208(d) of the Advisers Act, the proposed rule would prohibit an Adviser and its covered associates from otherwise doing indirectly, such as by channeling contributions to officials of government entities

through third parties such as spouses, attorneys or companies affiliated with the Adviser, what the rule prohibits them from doing directly.

Exemptive Relief. The proposed rule would permit an Adviser to seek an order from the SEC exempting it from the proposed rule's two-year time out requirement.

Recordkeeping Requirements. In conjunction with the proposed rule, the SEC proposes to amend Rule 204-2 under the Advisers Act to require a registered investment adviser to maintain certain records about its covered associates, its advisory clients, government entities invested in certain pooled investment vehicles managed by the adviser, the adviser's political contributions and the political contributions of its covered associates.

Public Comment. Comments on the proposed rule are due by October 6, 2009.

The Federal Reserve Bank of Cleveland Issues Policy Paper on Criteria for Systemically Important Financial Institutions

The Federal Reserve Bank of Cleveland has issued a [policy discussion paper](#) that proposes a set of criteria to identify systemically important financial institutions ("SIFIs") and recommends the development of a regulatory infrastructure based on the nature and source of their importance. The paper, entitled "*On Systemically Important Financial Institutions and Progressive Systemic Mitigation*" ("the SIFI Paper"), states that the regulation of SIFIs is one of the most important regulatory reform issues. The Obama Administration has proposed legislation regarding the consolidated supervision and regulation of SIFIs. For more on the Obama Administration's proposed legislation, please see the [July 28, 2009 Alert](#). The SIFI Paper asserts that establishing a financial stability supervisor alone will not achieve stability, it is also crucial to deal proactively with systemically important financial institution and have a workable definition of "systemically important." The resolution of SIFIs is not discussed in the SIFI Paper, but will be the subject of a forthcoming companion paper.

Size. According to the SIFI Paper, institutional size is not an adequate criterion for determining whether an institution is systemically significant and the "too big to fail" designation an oversimplification. Any size threshold could also capture large numbers of smaller, non-systemically significant institutions and potentially result in such smaller institutions becoming subject to unwarranted regulatory burdens. However, the SIFI Paper states that as a starting point for a sized-based definition for systemic importance, a financial institution would be considered systemically important if it accounts for at least 10 percent of the activities or assets of a principal financial sector or financial market or 5 percent of total financial market activities or assets.

Four C's. As an alternative to a size-based definition of systemic importance, the SIFI Paper identifies four risk factors that would make institutions of varying sizes potentially systemically important, the so-called "four C's" of systemic importance: contagion, correlation, concentration, and conditions/context:

- *Contagion:* A financial institution would be considered systemically important if its failure could result in (i) substantial capital impairment of financial institutions accounting for a combined 30 percent of the assets of the financial system, (ii) the locking up or material impairment of essential payments systems (domestic or

international), and (iii) the collapse or freezing up of one or more important financial markets.

- *Correlation:* In some cases, a single institution alone would not pose a systemic risk, but a group of institutions, acting in lockstep, would. The SIFI Paper refers to this as “too many to fail” and associates it with observed “herding behavior” in the financial system. There are two important aspects of correlation risk. First are the incentives for institutions to take on risks that are highly correlated with other institutions because policymakers are less likely to close an institution if many other institutions would become decapitalized at the same time. Second is the potential for largely uncorrelated risk exposures to become highly correlated in periods of financial stress. The SIFI Paper identifies correlated risks arising from financial or economic shocks that would make groups of financial institutions systemically important.
- *Concentration:* A financial institution would be considered systemically important if its failure could materially disrupt a financial market or payments system, causing economically significant spillover effects that impede the functioning of broader financial markets and/or the real economy. Thresholds for concentration that would render a financial institution systemically important would include any firm (on a consolidated basis) that (i) clears and settles more than 25 percent of trades in a key financial market, (ii) processes more than 25 percent of the daily volume of an essential payments system, or (iii) is responsible for more than 30 percent of an important credit activity.
- *Conditions/Context:* In certain circumstances, financial institutions would become systemically important due to macro-economic conditions. The SIFI Paper proposes two sets of criteria to classify firms that are systemically important due to context. The first is the probability that economic or financial conditions will materialize that produce the macro-economic conditions under which an institution or group of institutions becomes systemically important. The second are the thresholds for systemic importance, which would be based on those used to classify SIFIs according to contagion, concentration, and correlation during normal market conditions; which thresholds are applied would depend on which type of systemic importance the conditions produce. The SIFI Paper states that conditional or contextual risk is the most difficult of the four risk categories to identify in advance.

SIFI Categories. The SIFI Paper outlines five categories of financial institutions, of which only the first three would contain SIFIs:

- *Category 1:* Financial institutions that would be considered systemically important on the basis of size or concentration.
- *Category 2:* Financial institutions that would be considered systemically important because of contagion.
- *Category 3:* Financial institutions that would be considered systemically important as a group because of correlated risk exposures. Also included in this category would be financial institutions that are systemically important because of conditions or context.
- *Category 4:* Large financial institutions that would not be considered systemically important, but whose failure could have economically significant implications for

regional economies. This category would include large regional banking companies and large insurance companies.

- *Category 5*: Financial institutions not included in the other categories, consisting primarily of community financial institutions.

Regulation and Reporting. In order to identify institutions in one or more risk categories, the SIFI Paper states that banking supervisors should be required to conduct periodic systemic risk analyses, stress tests, and other simulations as part of a contingency planning process. The SIFI Paper proposes that SIFIs be subject to additional regulatory requirements such as increased capital requirements, portfolio restrictions, increased loss reserves, limits on counterparty exposure and mandatory debt-structure requirements. Such regulatory requirements would become more robust for, or would only apply to, SIFIs in higher SIFI categories. The SIFI Paper notes that transparency and information disclosure will be a major issue that must be vetted when new regulatory and supervisory architecture is put in place, and recommends full transparency in the determination of SIFIs, including publishing the full list of SIFIs, the criteria for inclusion in a SIFI category, and a “watch list” of financial institutions whose systemic risk status was likely to change in the near future.

SEC Staff Grants No-Action Relief Regarding Investment by Foreign Funds in U.S. Registered Funds

The staff of the SEC’s Division of Investment Management (the “Staff”) issued a [no-action letter](#) in which it provided assurances that it would allow an unregistered foreign investment company (a “Foreign Fund”) to invest in a U.S. investment company (a “U.S. Fund”) registered under the Investment Company Act of 1940, as amended (the “1940 Act”), in excess of certain limits in Section 12(d)(1)(A) of the 1940 Act. Section 12(d)(1)(A) of the 1940 Act generally prohibits an investment company, which includes a foreign collective vehicle like a Foreign Fund that meets the 1940 Act’s definition of investment company, and companies it controls, from (i) acquiring more than 3% of a registered investment company’s outstanding voting securities; (ii) investing more than 5% of its total assets in any one registered investment company; or (iii) investing more than 10% of its total assets in registered investment companies in the aggregate. Under the relief, a Foreign Fund may exceed the second and third limitations but would need to comply with the first. Investments in a U.S. Fund by a Foreign Fund would also need to comply with the requirements of Section 12(d)(1)(B), such that a U.S. Fund may not sell the U.S. Fund’s shares to a Foreign Fund or companies the Foreign Fund controls if the sale would cause (i) the acquiring Foreign Fund and companies it controls to own more than 3% of the U.S. Fund’s outstanding voting securities; or (ii) all investment companies (including the Foreign Fund) and any companies controlled by them to own more than 10% of the U.S. Fund’s voting securities. Additional conditions of the relief are that (a) each Foreign Fund will not offer or sell securities in the U.S. or to any U.S. person as defined in Rule 902(k) of Regulation S under the Securities Act of 1933; and (b) each Foreign Fund’s transactions with its shareholders will be consistent with the definition of “offshore transactions” in Regulation S.

Congressional Oversight Panel Issues Report on Continued Risk of Troubled Assets

The Congressional Oversight Panel (“COP”) issued a report entitled “The Continued Risk of Troubled Assets” (the “Report”). The [Report](#) states that because the Treasury determined to use Troubled Asset Relief Program (“TARP”) funds to provide capital directly to banks rather than to purchase the banks’ troubled loans, substantial troubled assets remain on the banks’ balance sheets today. The Report states that “[i]f the economy worsens, especially if unemployment remains elevated or if the commercial real estate market collapses, then defaults will rise and the troubled assets will continue to deteriorate in value.”

The Report next notes that the Treasury is now trying to restart the mortgage-backed asset market by moving forward with the Public-Private Investment Program (“PPIP”), but the Report cautions that accounting rules that allow banks to carry assets at higher valuations than market might make banks unwilling to sell and buyers may be concerned about political interference or governmental restrictions. In addition, the Report expresses concern that small banks, which have not been subject to the stress tests imposed on the largest 19 banks, may be hit hard by credit deterioration, and the Report notes that smaller banks tend to have a harder time raising capital to offset the loan write-offs. Furthermore, the Report advocates regulatory imposition of stronger disclosure requirements that would lead to greater disclosure by banks of the terms and volume of troubled assets on their balance sheets.

SEC Staff Grants No-Action Relief to Allow Advisers to Rely on Confirmation Transmission Service to Meet Advisers Act Recordkeeping Requirements

The staff of the SEC’s Division of Investment Management (the “staff”) granted [no-action relief](#) that will allow an investment adviser registered under the Investment Advisers Act of 1940 (the “Advisers Act”) to rely on a third party service (the “Service”) that currently provides the adviser with trade confirmations for client transactions in electronic form to also maintain those confirmation records in a manner that satisfies the adviser’s recordkeeping obligations under the Advisers Act with respect to client trade confirmations. Absent the the relief, an adviser using the Service for electronic confirmation delivery must download or print copies of the electronically transmitted confirmations. If an adviser engages it for recordkeeping purposes, the Service will store at least two electronic copies of each trade confirmation for not less than five years from the end of the fiscal year during which the last entry was made on the confirmation, with at least one copy stored in a separate, secure facility. During the retention periods specified in the Advisers Act recordkeeping rules, an adviser will be able, at any time, to access confirmations kept by the Service using computers in the adviser’s offices. An adviser that stops using the Service for recordkeeping purposes may request in writing copies of any confirmation maintained by the Service for not less than five years from the end of the fiscal year during which the Service last made an entry on the confirmation. If an adviser that has used the Service ceases operations without making adequate provision for its ongoing recordkeeping obligations under Advisers Act Rule 204-2(f), the Service will provide the SEC without charge within 24 hours of a request an electronic copy of any confirmation maintained for the adviser for not less than five years after the end of the fiscal year during which the Service last made an entry on the confirmation. In the event the Service ceases operations, it will make arrangements reasonably acceptable to the SEC or

its staff to ensure the continued availability of adviser records for regulatory purposes during the remainder of the applicable recordkeeping periods. The Service's internal systems for making and keeping confirmations on behalf of an adviser will meet all of the requirements for electronic recordkeeping under Advisers Act Rule 204-2(g).

SEC Grants No-Action Relief Related to Repurchases of Auction Rate Securities

The SEC staff recently granted affiliated broker-dealers (collectively, the "Broker-Dealer") and related entities [no-action relief](#) from certain provisions of the Investment Company Act of 1940, as amended (the "1940 Act"), and the Securities Exchange of 1934, as amended (the "1934 Act"), with respect to a series of transactions contemplated in connection with settlements (the "Settlements") previously reached by the Broker-Dealer with the SEC and certain state regulatory authorities. Pursuant to the Settlements, the Broker-Dealer is required to purchase auction preferred stock ("APS"), issued by certain registered investment companies and held by its current clients, at par value plus accrued and unpaid interest or dividends. (For additional background on APS, please see the [July 1, 2008 Alert](#)). The Broker-Dealer proposes to refinance its purchase of the APS by selling the APS it purchases to certain unregistered trusts (the "Trusts") to be formed with the Broker-Dealer's involvement. In turn, the Trusts will sell (i) instruments similar to floating rate notes that are designed to be eligible for purchase by money market funds (the "Floaters"), and (ii) other residual securities, which will be purchased by an affiliate of the Broker-Dealer. The Floaters will include a liquidity facility under which a liquidity provider is contractually obligated to purchase Floaters from their holders in the event one of the periodic remarketings, which are a feature of the Floaters, fails.

Noting that the Floaters' liquidity features are analogous to the liquidity features described in the [Eaton Vance](#) and [Merrill Lynch](#) no-action letters dealing with liquidity provider arrangements (the "Previous Relief"), the request for relief sought confirmation that the Floaters could be considered eligible investments for money market funds relying on Rule 2a-7 under the 1940 Act based on the similarity of their liquidity provider arrangements to those in the Previous Relief even though unlike in the Previous Relief the liquidity provider in the current instance could be an affiliate of the Broker-Dealer. In addition to that confirmation, the SEC staff granted relief from:

- various 1940 Act provisions that could cause the Broker-Dealer or a Trust to be an affiliated person or affiliated person of an affiliated person of a Fund (and thus subject to various restrictions under the 1940 Act) as a result of the contemplated purchases of APS;
- Section 12(d)(1)(A)(i) of the 1940 Act to the extent it could be deemed to limit a Trust's purchase of APS; and
- Section 14(e) and Regulation 14E of the 1934 Act, to the extent a Liquidity Provider's offer to purchase Floaters could be deemed a tender offer.

The request for relief noted reliance on the SEC's prior [global exemptive relief](#) regarding ARPs that was granted generally with respect to a series of settlements with broker-dealers regarding their customers' purchase of APS.

OTHER ITEMS OF NOTE

Massachusetts Regulator Announces Amendments to Data Security Regulations and Delay of Compliance Date until March 1, 2010

The Massachusetts Office of Consumer Affairs and Business Regulation (the “OCABR”) issued a revised version of the Massachusetts data security regulations (201 CMR 17.00), that were originally adopted in 2008. The compliance date for the revised regulations will be March 1, 2010. In an accompanying notice, the OCABR indicated that it will hold a hearing Tuesday, September 22, 2009 on the revised regulations and will accept written comments until the close of business on September 25, 2009. Goodwin Procter will provide more detailed coverage of this development in a separate client alert that will be sent to *Alert* readers.

SEC Reopens Comment on Proposed Short Sale Restrictions under Reg. SHO and Requests Comment on Alternative Uptick Rule

The SEC [announced](#) that it is reopening the comment period on amendments to Reg. SHO discussed in [SEC Release No. 34-59748 \(Apr. 10, 2009\)](#), in which the SEC proposed two approaches to restrictions on short selling: one that would apply on a market-wide and permanent basis and one that would apply only to a particular security during a severe market decline in the price of that security. Although the comment period is reopened on all aspects of the April proposals, the current request for comment focuses on use of the alternative uptick rule, which would restrict short selling market-wide on an ongoing basis by allowing short selling only at a price above the current national best bid. The reopened comment period continues through the 30th day following publication of the announcement in the *Federal Register*.

FRB and Treasury Announce Extension to Term Asset-Backed Securities Loan Facility

The FRB and the Treasury have announced the extension of the Term Asset-Backed Securities Loan Facility (the “TALF”). For more on the TALF, please see the [May 5, 2009 Alert](#). The FRB and the Treasury approved extending TALF loans against newly issued asset-backed securities and legacy commercial mortgage-backed securities (“CMBS”) through March 31, 2010. Because new CMBS deals can take a significant amount of time to arrange, the FRB and the Treasury approved TALF lending against newly issued CMBS through June 30, 2010. The FRB stated that it will continue to monitor financial conditions and will consider in the future whether unusual and exigent circumstances warrant a further extension of the TALF to help promote financial stability and economic growth. The FRB and the Treasury also announced that they are holding in abeyance any further expansion in the types of collateral eligible for the TALF.

SEC Publishes Adopting Release for Regulation S-AM Requiring Certain Consumer Opt Out Rights to Affiliate Marketing

The SEC published the [adopting release](#) for Regulation S-AM which limits a person’s use of “eligibility information” received from an affiliate to solicit a consumer for marketing purposes, unless the consumer has been given notice and a reasonable opportunity and a reasonable and simple method to opt out of such solicitations. The final rules implement

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requirements of the Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act of 2003, that also apply to the federal banking agencies and the FTC. Goodwin Procter will be issuing a client alert that discusses Regulation S-AM in greater detail and compares it to regulations already adopted by the federal banking agencies and the FTC. The new rule, which applies to investment advisers, transfer agents, brokers, dealers and investment companies registered with the SEC has a January 1, 2010 compliance date.

Supreme Court Schedules Oral Argument for Review of Seventh Circuit Decision in Harris Associates

The U.S. Supreme Court has scheduled oral argument in its review of the decision by the US Court of Appeals for the Seventh Circuit in *Jones v. Harris Associates L.P.*, 527 F.3d 627 (7th Cir. 2008), an excessive fee suit under Section 36(b) of the Investment Company Act of 1940, for Monday, November 2, 2009, at 10:00 a.m. For more on this case, see the [March 10, 2009](#) and [June 3, 2008](#) Alerts.