Issue 3, Third Quarter 2009

REGULATORY ADMINISTRATION DIGEST

A summary of mutual fund regulatory updates for the second quarter of 2009

The President's plan will include measures to strengthen the current regime for regulating and supervising financial firms.

President Obama Announces Financial Reform Plan

The U.S. Department of the Treasury issued a plan for financial reform on June 17, 2009 in its whitepaper titled *Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation*. According to the whitepaper, the President's plan will:

- increase oversight of systemic risk and financial regulation with the creation of a financial services oversight council;
- boost regulation for large, interconnected financial firms;
- set higher capital and management requirements for all financial holding companies;
- create a new national bank supervisor and eliminate the Federal thrift charter and loopholes in the Bank Holding Company Act; and
- require advisers to hedge funds and other private pools of capital to register with the Securities and Exchange Commission (SEC).

The white paper also states that the SEC should move forward with its plans to strengthen the regulatory framework around money market funds, including:

(1) requiring money market funds to maintain substantial liquidity buffers;
(2) reducing the maximum weighted average maturity of money market funds;
(3) tightening credit concentration limits;
(4) improving credit risk analyses and management of money market funds; and
(5) empowering money market fund boards of directors to suspend redemptions in extraordinary circumstances to protect the interests of fund shareholders.

While these measures are designed to enhance investor protection and lessen the risk of runs on money market funds, the whitepaper also recommends fundamental changes to address systemic risk more directly. The President's Working Group on Financial Markets (PWG) is expected to issue those additional recommendations by September 15, 2009.

The whitepaper also states that the SEC and PWG should carefully consider ways to mitigate any potential adverse effects of increased money market fund regulation, such as investor flight to less regulated money market investment vehicles, which suggests that further reforms could include a floating net asset value (NAV). The Group of 30 (G30), a private, nonprofit group of international representatives of the private and public sectors and academia, had previously recommended that money market mutual funds be prohibited from using amortized cost pricing and have a fluctuating NAV, as opposed to one that is pegged at $1.00 per share. The President's plan does not, however, mention other G30 proposals such as their proposal that stable-NAV money market mutual funds that offer “bank-like” services, such as check writing, be required to reorganize as special purpose banks and carry government insurance.

SEC Proposes Changes to Money Market Fund Regulation

The proposed amendments are designed to significantly strengthen the regulatory framework for money market funds, increase their resilience to economic stresses and reduce the risk of runs on the funds.

On June 24, 2009, the Securities and Exchange Commission (SEC) voted unanimously to propose amendments to the rules that govern money market funds under the Investment Company Act of 1940, as amended (1940 Act). These amendments are consistent with the recommendations proposed by the Money Market Working Group of the Investment Company Institute (ICI) in March.

Generally, the proposed amendments would tighten the risk-limiting conditions of Rule 2a-7 of the 1940 Act; require money market funds to report their portfolio holdings monthly to the SEC; and permit a money market fund that has “broken the buck” to suspend redemptions to allow for the orderly liquidation of fund assets. Additionally, the SEC is seeking comment on other potential changes to its regulation of money market funds, including whether money market funds should, like other types of mutual funds, have “floating” rather than stabilized net asset values and whether to require that funds provide in-kind redemptions to satisfy redemption requests in excess of a certain size.

In tightening the risk-limiting conditions of Rule 2a-7, the proposed amendments would require increased portfolio quality and liquidity and limited portfolio maturity. Regarding portfolio quality, the amendments would further limit the amount of credit risk exposure to which money market funds are subject by prohibiting the funds from investing in Second Tier securities, as defined in Rule 2a-7. Eligible securities would be redefined as securities receiving only the highest, rather than the highest two, short-term debt ratings from a requisite nationally recognized securities rating organization. Further, money market funds would be permitted to acquire long-term unrated securities only if they have received long-term ratings in the highest two, rather than the highest three, ratings categories. The SEC proposal seeks to limit portfolio maturity by, among other means, shortening the weighted average maturity limits for money market funds from 90 days to 60 days. These changes to Rule 2a-7’s maturity limits would limit the exposure of investors to certain risks, including interest rate risk. Finally, the SEC is proposing adding new risk limiting conditions to Rule 2a-7 that are designed to improve money market funds’ ability to meet significant redemption demands. This includes limitations on the acquisition of illiquid securities, requiring funds to have a minimum percentage of their assets in securities that can be readily converted to cash and the requirement that the board of directors of each money market fund using the amortized cost method adopt procedures providing for periodic stress testing of the fund’s portfolio.

In order to increase transparency, the SEC’s proposal would amend Rule 2a-7 to require money market funds to disclose information about their portfolio holdings each month on their web sites. Specifically, a fund would be required to disclose the fund’s schedule of investments identifying the issuer, the title of the issue, the principal amount of the security and its current amortized cost. Additionally the proposal would require money market funds to provide monthly an electronic filing with the SEC containing more detailed portfolio holding information. The SEC intends to use this information to create a central database of portfolio holdings that would enhance its oversight of money market funds and its ability to respond to market events.

In an effort to reduce the vulnerability of money market fund investors from the harmful effects of a run on the fund in the event of a fund “breaking the buck,” the SEC is proposing a new Rule 22e-3 that would exempt money market funds from Section 22(e) to permit them to suspend redemptions in order to facilitate an orderly liquidation of the fund. The new rule would replace Rule 22e-3T, a temporary rule that provides a similar exemption for money market funds that participated in the Treasury Department's Temporary Guarantee Program for Money Market Funds. Proposed rule 22e-3 would permit a money market fund to suspend redemptions if: (i) the fund's current price per share, calculated pursuant to Rule 2a-7(c), is less than the fund's stable net asset value per share; (ii) the fund's board of directors, including a majority of directors who are not interested persons, approves the liquidation of the fund; and (iii) the fund, prior to suspending redemptions, notifies the SEC of its decision to liquidate and suspend redemptions via email.

The SEC is seeking comments on its proposed changes to money market fund regulation on or before September 8, 2009.

SEC Proposes Proxy Access Amendments

The new rules would require companies, under certain circumstances, to include a shareholder's or group of shareholders' nominees for director in the company's proxy materials.

On May 20, 2009, the Securities and Exchange Commission (SEC) voted to propose a series of rule amendments that would facilitate the rights of shareholders to nominate directors of corporate boards. Under the SEC's proposed Rule 14a-11 of the Securities Exchange Act of 1934 (Exchange Act), certain shareholders may require a company to include shareholder nominees for director in the company's proxy materials, unless otherwise prohibited by law or the company's governing documents.

Shareholders would be eligible to include director nominees in the proxy materials if:

(1) they own at least one percent of the voting securities of a "large accelerated filer" (a company with a worldwide market value of $700 million or more) or of a registered investment company with net assets of $700 million or more;
(2) they own at least three percent of the voting securities of an "accelerated filer" (a company with a worldwide market value of between $75 million and $700 million) or of a registered investment company with net assets of between $75 and $700 million; or
(3) they own at least five percent of the voting securities of a non-accelerated filer (a company with a worldwide market value of less than $75 million) or of a registered investment company with net assets of less than $75 million.

Shareholders may form shareholder groups and aggregate their shares to meet the required ownership threshold. Furthermore, shareholders would be required to have held their shares for at least one year; sign a document declaring their intent to continue to own their shares through the annual meeting at which directors are elected; and certify that they are not holding their stock for the purpose of changing control of the company or to gain more than minority representation on the board of directors. A shareholder would be able to include no more than one director nominee, or a number of nominees that represents up to 25 percent of the company's board of directors, whichever is greater, in company proxy materials.

The SEC's proposed rule amendments also include an amendment to Rule 14a-8(i)(8) under the Exchange Act. Under the proposed amendment, shareholders could require companies, under certain circumstances, to include proposals in their proxy materials that would amend, or request an amendment to, the company's governing documents to address the company's nomination procedures. Currently, Rule 14a-8(i)(8) permits companies to exclude shareholder proposals that "relate to an election." The eligibility provisions of Rule 14a-8 would continue to apply under the proposed amendment, which require that a shareholder have continuously held at least $3,000 in market value, or one percent, whichever is less, of the company's securities entitled to be voted at the upcoming shareholder meeting, for a period of one year prior to submitting the proposal.

Comments on the proposed rule amendments must be submitted to the SEC no later than August 17, 2009.

SEC Issues No-Action Letter Regarding Investment Company Participation in Term Asset-Backed Securities Loan Facility (TALF)

The Securities and Exchange Commission (SEC) recently issued a no-action letter addressing regulatory issues resulting from mutual funds' and closed-end funds' participation in the Term Asset-Backed Securities Loan Facility (TALF). Concerns arose when the program was announced by the Federal Reserve Bank of New York (New York Fed) that mutual funds may have difficulty participating in TALF due to a restriction in Section 18(f) of the Investment Company Act of 1940, as amended (1940 Act). Section 18(f) requires a fund's net asset value to equal 300% of the value of any senior securities. Under Section 18(f), the senior security is the fund's obligation to repay the TALF loan. Although the terms and conditions of the TALF specifically include "investment funds" in the definition of "eligible borrowers," it was previously thought that mutual funds and closed-end funds would have to adhere to the asset coverage requirements of Section 18 in order to participate.

The SEC stated in its no-action letter dated June 19, 2009 that it would not recommend enforcement action against a registered closed-end or open-end investment company if the fund participates in the TALF and does not treat the TALF borrowing as a senior security representing indebtedness for purposes of compliance with Section 18 of the 1940 Act.

The TALF was designed to increase credit available to consumers and businesses by facilitating the issuance of asset-backed securities (ABS).

Under the program, the New York Fed provides loans to investors, including mutual funds, for the purchase of eligible ABS. Eligible ABS include U.S. dollar-denominated ABS with underlying credit exposures to U.S.-domiciled obligors of auto loans, student loans, credit card loans, equipment loans and Small Business Association-guaranteed small business loans.

As a condition to the no-action letter, however, the SEC stated that fund must segregate liquid assets in an amount equal to the fund's outstanding principal and interest on the TALF loan. These assets cannot be the ABS securities that collateralize the borrowing.

The SEC also said it would not recommend an enforcement action under Section 17(f) of the 1940 Act against a fund with respect to the fund's participation in the unique custody arrangements necessitated by the TALF program. The TALF terms and conditions require primary dealers briefly to hold investor assets, where such arrangements are not structured to comply with Rule 17(f).

FTC's "Red Flags" Deadline Extended to August 1, 2009

On November 7, 2007, the Federal Trade Commission (FTC), along with several other regulatory agencies, issued final rules and guidelines implementing Section 114 of the Fair and Accurate Credit Transactions Act of 2003. The rules implementing Section 114 require each financial institution or creditor to develop and implement a written

Identity Theft Prevention Program to detect, prevent, and mitigate identity theft in connection with the opening of certain accounts or certain existing accounts (red flags rules). The program must include reasonable policies and procedures to identify, detect and respond to red flags, or to those patterns, practices, or specific activities that indicate the possible existence of identity theft. Implementation of a program, which requires action by a fund's board of directors or designated committee, was initially required by November 1, 2008.

By definition, the entities subject to the red flags rules are creditors and financial institutions. A financial institution is defined as "any of certain depository institutions, or any other person that, directly or indirectly, holds a transaction account (as defined in section 19(b) of the Federal Reserve Act) belonging to a consumer." Initially it was thought that this rule would not apply to mutual funds, as the only financial institutions that the FTC had jurisdiction over were state-chartered credit unions. In an attempt to clarify, the FTC issued a Business Alert in June 2008 stating that its jurisdiction also included "certain other entities that hold consumer transaction accounts," but it did not specify whether mutual funds were included in the rule. On July 17, 2008, however, the Investment Company Institute (ICI) issued an Urgent Memorandum to investment companies indicating that investment companies with transaction accounts would be required to implement an identity theft prevention program in compliance with the FTC's red flags rules. It was not until the FTC issued a "How-To Guide" in March 2009 that the FTC indicated that mutual funds may be subject to the red flags rules. The guide stated, "Examples of financial institutions under the FTC's jurisdiction are state-chartered credit unions, mutual funds that offer accounts with check-writing privileges, or other institutions that offer accounts where the consumer can make payments or transfers to third parties."

On October 22, 2008, the FTC decided to delay enforcement of the red flags rules until May 1, 2009, stating that many entities had learned of the rule's requirements too late to be able to comply by the November 1, 2008 deadline.

On April 30, 2009, the FTC announced a further delay in enforcement until August 1, 2009 in order to give creditors and financial institutions more time to develop and implement written identity theft prevention programs.

Financial Accounting Standards Board Issues Staff Position FAS 157-4

On April 9, 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (FAS) 157-4, which revised valuation guidance on determining the fair value of assets and liabilities when the volume and level of activity for the asset or liability have significantly decreased. FAS 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly (i.e., a forced liquidation or distressed sale).

FAS 157-4 replaces FAS 157-3 which was issued in October 2008 and addressed the valuing of financial assets in inactive markets. It also supercedes proposed FAS 157-e issued in March of 2009 (and discussed in a past issue of this Digest) which proposed a two-step process for determining whether a market transaction is orderly.

FAS 157-4 applies to all assets and liabilities that require or permit fair value measurements, specifically, registered investment companies. It outlines a set of factors that a reporting entity should evaluate in order to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability when compared with normal market activity for that asset or liability. Once an evaluation is conducted, if the reporting entity determines that there has been a significant decrease in the volume and level of activity as compared to normal market conditions, transactions or quoted prices may not accurately determine fair value (i.e., there may be increased instances of transactions that are not orderly). In this instance, further analysis of the transactions or quoted prices is needed and a significant adjustment may be necessary to estimate fair value in accordance with FAS 157.

Custody Rule Amendments Strengthen Investor Safeguards

On May 20, 2009, the SEC proposed amendments to Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (Advisers Act). The amendments would require registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent accountant to verify client funds and securities. In addition, unless the client accounts are maintained by an independent qualified custodian, (i.e., a custodian other than the investment adviser or a related person), the investment adviser or related person must obtain a written report from an independent public accountant that includes an opinion regarding the custodian's controls relating to custody of client assets. The amendments are proposed following several recent enforcement actions by the SEC against investment advisers and broker-dealers involving fraudulent conduct, including misappropriation and other misuse of investor assets. Comments on the proposal are due on July 28, 2009.

Rule 24f-2 No-Action Letter

In response to a request letter submitted to the Securities and Exchange Commission (SEC) by Seward & Kissel LLP on April 15, 2009, the Staff has issued a no-action letter announcing that they will not recommend enforcement action to the SEC under Section 24(f) of the Investment Company Act of 1940 (1940 Act) and Rule 24f-2 thereunder against any open-end management investment company that does not deduct redemption fees when calculating the price of securities redeemed or repurchased in item 5(ii) of Form 24F-2.

Section 24(f)(2) of the 1940 Act requires a mutual fund to pay a registration fee to the SEC based upon the aggregate sales price of shares sold during its fiscal year, reduced by the aggregate price of shares redeemed or repurchased during its fiscal year. The purpose of this netting is to charge a mutual fund a registration fee based on annual growth. If a mutual fund charges a redemption fee to discourage short-term trading and market timing of its shares, and this fee is deducted from the aggregate price of shares redeemed or repurchased, the fund will be paying registration fees on the redemption fees, which are not true indicators of growth. In the absence of the SEC's no-action letter, mutual funds might have been reluctant to charge redemption fees due to the artificial increase in registration fees.

The SEC Staff stated that its no-action letter expressed a position on enforcement action only and not a legal conclusion.

Amicus Brief in Jones v. Harris Associates Points Toward SEC's Interpretation of Section 36(b) of the Investment Company Act of 1940

The brief is significant because it may be viewed as the SEC's interpretation of Section 36(b) of the Investment Company Act of 1940, as amended (1940 Act).

The Office of the Solicitor General and the Securities and Exchange Commission (SEC) filed an amicus brief for the United States with the U.S. Supreme Court in regard to the case of Jones v. Harris Associates (7th Cir. May 19, 2008). Section 36(b) of the 1940 Act provides that a court shall give such consideration to the approval of investment advisory fees by the board of directors as it deems appropriate under the circumstances. The question at issue in Jones is whether a security holder's claim that an investment adviser has breached its fiduciary duty by charging excessive fees to a fund can be tried under Section 36(b) if the investment adviser is not shown to have misled the directors of the fund who approved the fees. The case reached the Supreme Court by way of U.S. Court of Appeals for the Seventh Circuit. The Seventh Circuit had rejected the plaintiffs' allegation of excessive advisory fees and ruled that an investment adviser's compensation is not subject to judicial review for reasonableness when there has been full disclosure of the fees and approval by the fund's directors. The Seventh Circuit's decision rejected the standard set by the Second Circuit in Gartenberg v. Merrill Lynch Asset Management, (2nd Cir. 1982). The court in Gartenberg held that when determining whether a fund adviser has breached its fiduciary duty by charging excessive fees, the test is whether the advisory fee represents a charge so disproportionately large that it "bears no reasonable relationship to the services rendered and could not have been negotiated at arm's-length." The amicus brief in Jones gives little weight to the position of the Seventh Circuit, asserting that the Gartenberg standard is the appropriate way to resolve 36(b) cases.

In contrast, the petitioner's brief in the Jones case argues that the Gartenberg standard was correctly decided but misconstrued by later courts because the Section 36(b) fiduciary duty imposes two requirements. First, an investment adviser must fully disclose all material facts regarding its compensation. Second, the compensation must be fair to the fund, comporting with what would have resulted from an arm's-length negotiation. The petitioner's standard appears similar to a standard recently approved in the Eighth Circuit in Gallus v. Ameriprise Financial, Civil Action No. 07-2934 (8th Cir. Apr. 8, 2009). If the Supreme Court reverses, it will face a choice between the Gartenberg standard and the Gallus standard. In both cases, fees charged institutional clients would be relevant if the services provided to those clients were comparable to those provided to investors.

Regulatory Administration Group

For further information, contact:

Owen Meacham, Esq.
otm1@ntrs.com
312.557.3948

Gwen Cooney
gcc3@ntrs.com
312.557.2013

Shanna Palmersheim, Esq.
sp141@ntrs.com
312.557.8746

Robert P. Mitchell
rpm4@ntrs.com
312.444.5811

Regulatory Administration Digest is compiled by our Regulatory Administration Group.