

REGULATORY ADMINISTRATION DIGEST

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

SEC Adopts Amendments Eliminating References to NRSROs

Effective November 12, 2009, the Securities and Exchange Commission (SEC) adopted amendments (Amendments) to Rules 5b-3 and 10f-3 under the Investment Company Act of 1940 (1940 Act) removing references to nationally recognized statistical ratings organizations (NRSROs).

Prior to the adopting the Amendments, four of the rules under the 1940 Act (Rules 2a-7, 3a-7, 5b-3 and 10f-3) and one rule under the Investment Advisers Act (Rule 206(3)-3T) referenced credit ratings by NRSROs. The SEC noted in its final rule release that most commentators opposed the proposed amendments, which removed references to NRSRO ratings and substituted alternative provisions designed to achieve the same purpose as the ratings. In response, the SEC's final rule release limits removal of references to NRSROs only in Rules 5b-3 and 10f-3. As stated in the release, the Amendments are designed to reduce "undue reliance on credit ratings" and "advance the goal of promoting better analysis of underlying investment decisions."

Under the 1940 Act, Section 10(f) prohibits a registered investment company from knowingly purchasing any security for which an affiliated underwriter is acting as a principal underwriter during the existence of an underwriting syndicate for that security. According to the SEC's final rule release, "[t]he prohibition was designed to prevent the "dumping" of unmarketable securities on affiliated funds, either by forcing the fund to purchase unmarketable securities from the underwriting affiliate itself or by forcing or encouraging the fund to purchase the securities from another member of the syndicate." Under Rule 10f-3, a fund may purchase securities from an affiliated underwriter or another member of the syndicate if certain conditions designed to mitigate the risks of such purchase are met.

In 1979, Rule 10f-3 was amended to add municipal securities to the class of securities that a fund could purchase under the rule. Formerly, Rule 10f-3 stated that "eligible municipal securities" must have an investment grade rating (one of the four highest ratings) from at least one NRSRO or, if the issuer or the entity supplying the revenues or other payments from which the issue is to be paid has been in continuous operation for less than three years (*i.e.*, the security is a less seasoned security), one of the three highest ratings from an NRSRO.

The Amendments eliminate references to NRSRO ratings and revise the definition of "eligible municipal security" under Rule 10f-3 to mean securities that are sufficiently liquid that they can be sold at or near their carrying value within a reasonably short time period. Additionally, the securities would have to be either: (1) subject to no greater than

The Amendments follow several credit ratings initiatives by the SEC last year, including proposed rules in furtherance of the Credit Rating Agency Reform Act of 2006 and proposed amendments eliminating references to credit ratings throughout the 1940 Act and Investment Advisers Act of 1940.

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moderate credit risk; or (2) if they are less seasoned securities, subject to a minimal or low amount of credit risk.

The final rule release outlines the test for minimal and moderate credit risk:

A municipal security (or its issuer) subject to a moderate level of credit risk would present average creditworthiness relative to other municipal or tax exempt issues or issuers. Moderate credit risk also would denote current low expectations of default risk, with an adequate capacity for payment of principal and interest. Municipal securities subject to minimal or low credit risk would be less susceptible to default risk (*i.e.*, have a low risk of default) than those with moderate credit risk. These securities (or their issuers) also would demonstrate a strong capacity for principal and interest payments and present above-average creditworthiness relative to other municipal or tax exempt issues (or issuers).

Existing provisions in Rule 10f-3 require a fund's board of directors, including a majority of disinterested directors, to (1) approve procedures under which the fund purchases securities under the rule, (2) approve any needed changes to those procedures and (3) review purchases quarterly to assure that they conformed to the fund's procedures. According to the final rule release, these provisions will continue to apply to affiliated underwritings under the amended rule, and the board's responsibilities with regard to fund procedures will apply to the new standards in the rule regarding liquidity and credit quality.

The Amendments also remove references to NRSROs in Rule 5b-3 of the 1940 Act, which governs diversification requirements for "refunded securities." Under Rule 5b-3, a "refunded security" is a debt security whose principal and interest payments are to be paid by U.S. government securities that have been irrevocably placed in an escrow account and are pledged only to the payment of the debt security. Section 5(b)(1) of the 1940 Act limits the amount that a fund that holds itself out as being "diversified" may invest in the securities of any one issuer (other than the U.S. Government). A diversified investment company is generally limited to investing no more than 5 percent of the value of its total assets and no more than 10 percent of the outstanding voting securities in any one issuer. Rule 5b-3 permits a fund that acquires a refunded security to treat it as an acquisition of the escrowed government securities for purposes of the diversification requirements of Section 5(b)(1) of the Act, if certain conditions are met.

One of the conditions of Rule 5b-3 is that an independent certified public accountant must have certified to the escrow agent that the escrowed securities will satisfy all scheduled payments of principal, interest, and applicable premiums on the refunded securities. Previously, this condition was not required if the refunded security received a debt rating in the highest rating category from an NRSRO. Under the Amendments, the SEC has eliminated the exception for refunded securities with certain credit ratings. The amended Rule 5b-3 provides that an independent accountant must have certified to the escrow agent that the deposited securities will satisfy all scheduled payments of principal, interest and applicable premiums on the refunded securities. Thus, according to the SEC final rule release, the same standard will apply for securities with the highest NRSRO debt rating as currently apply to those that have received lower or no ratings. The SEC further stated in its final rule release that because accountant certifications are typically provided during the course of a refunding transaction, it believes that it will not be difficult or



expensive for fund managers to confirm that the certification has been provided to the escrow agent.

In a related action, the SEC deferred consideration of proposed amendments to Rules 2a-7, 3a-7, and additional references in 5b-3 under the 1940 Act and Rule 206(3)-3T under the Investment Advisers Act, in response to comments received on the proposed amendments. The SEC requested specific comments on the proposed amendments as outlined in the release by December 8, 2009.

SEC Adopts Proxy Disclosure Enhancements for Investment Management Companies

At its open meeting held on December 16, 2009, the Securities and Exchange Commission (SEC) adopted rule amendments that provide for new or revised disclosures regarding risk, governance and director qualifications and compensation. These amendments apply to disclosure rules regarding proxy and information statements, annual reports and registration statements and are effective February 28, 2010. With respect to investment management companies, the new rules require additional disclosure regarding: 1) director and nominee qualifications; 2) past directorships held by directors and nominees; 3) legal proceedings involving directors, nominees, and executive officers to funds; and 4) new disclosure about the board of directors' leadership structure and the board's role in the oversight of risk.

Investment management companies that file registration statements on Forms N-1A or N-2 or proxy statements on Schedule 14A must include additional disclosure regarding director and nominee qualifications. In addition to the previously required information regarding director and nominee business experience during the past five years, the new rules require registrants to discuss the specific experience, qualifications, attributes, or skills that led to the conclusion that such person should serve as a director for a Fund in light of the Fund's business and structure. This disclosure should cover more than the past five years if a Fund decides that such information regarding a director's or nominee's particular expertise or relevant qualifications is material.

Funds must also indicate any directorships held during the past five years by each director or director nominee in: 1) public companies - any company with a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (the Exchange Act) or subject to the requirements of 15(d) of the Exchange Act; or 2) investment management companies - any company registered as an investment company under the Investment Company Act of 1940, as amended (the 1940 Act).

The new disclosure requirements lengthen the reporting period for legal proceedings involving directors, director nominees and executive officers from five years to 10 years for investment management companies that file proxy statements on Schedule 14A. Moreover, the new rules expand the list of legal proceedings involving directors, nominees and executive officers that must be disclosed in a proxy statement. The new legal proceedings include:

- any judicial or administrative proceedings resulting from involvement in mail or wire fraud or fraud in connection with any business entity;
- any judicial or administrative proceedings based on violations of federal or state securities, commodities, banking or insurance laws or regulations, or any settlement to such actions, other than settlement of a civil proceeding among private parties; and



- any disciplinary sanctions or orders imposed by a stock, commodities or derivatives exchange or other self-regulatory organization.

Finally, the new rules require that a Fund describe the leadership structure of the Fund's board, including the responsibilities of the board of directors with respect to the Fund's management, and the board's role in risk oversight. A Fund must disclose if the chairman of the Fund's board is an "interested person" (as defined in Section 2(a)(19) of the Investment Company Act of 1940, as amended) and, if so, whether the Fund has a lead independent director and the role that the such director plays in the Fund's leadership. The disclosure should also explore why the Fund has determined its leadership structure is appropriate in light of the specific characteristics or circumstances of the Fund.

If an existing Fund's fiscal year ends on or after December 20, 2009, any registration statement, post-effective amendment to an existing registration statement or proxy statement filing must comply with the amendments if filed on or after February 28, 2010. An existing Fund whose fiscal year ends before December 20, 2009 that files a registration statement, post-effective amendment to an existing registration statement or proxy statement need not comply with the new disclosure requirements unless these filings are filed after the end of the Fund's 2010 fiscal year end. If a Fund is required to file a preliminary proxy statement and expects to file its definitive proxy statement on or after February 28, 2010, then the preliminary proxy statement must be in compliance with the new rules, even if the preliminary proxy is filed prior to February 28, 2010.

Treasury Temporary Guarantee Program for Money Market Funds Expires

On December 11, 2009, the U.S. House of Representatives passed the "Wall Street Reform and Consumer Protection Act of 2009" designed to increase oversight and regulation of U.S. banks and other corporations, provide for financial regulatory reform, protect consumers and investors, enhance Federal understanding of insurance issues and regulate the over-the-counter derivatives markets and private pools.

The bill creates several new agencies intended to monitor the financial industries and protect consumers: the Consumer Financial Protection Agency (CFPA), a Federal Insurance Office and an inter-agency oversight council to identify and regulate large financial firms.

Additionally, the bill establishes a process for dismantling large, failing financial institutions and gives shareholders an advisory vote on executive compensation and empowers federal regulators to ban risky compensation practices. Financial firms with at least \$1 billion in assets must disclose to financial regulators any incentive-based compensation structures.

From a regulatory perspective, there are several critical developments. The bill strengthens the SEC's powers to protect investors and regulate the national securities markets by ordering a study of the securities industry to identify necessary reforms that will improve investor protection. Most significantly, perhaps, the bill establishes regulation of the over-the-counter derivatives marketplace and of hedge funds, private equity and private pools. All standardized swap transactions between dealers and "major swap participants" (defined as "anyone that maintains a substantial net position in swaps, exclusive of hedging for commercial risk, or whose positions create such significant exposure to others that it requires monitoring") must now be cleared and traded on an exchange or electronic platform. Furthermore, advisers of private pools of capital must



register with the SEC and will be subject to systemic risk regulation by the Financial Stability regulator.

In an attempt to restore the integrity of the mortgage lending industry, the bill also incorporates the mortgage reform and anti-predatory lending bill the House passed earlier in 2009, outlawing many of the industry practices that marked the subprime lending boom. The bill requires that the industry follow basic principles to ensure that mortgage lenders make loans that are beneficial to consumers and borrowers can repay the loans that they are sold, and that the secondary mortgage market complies with these standards when buying loans and converting them into securities.

Lastly, the new legislation addresses the role that credit rating agencies played in the recent economic crisis by proposing several reforms. The bill attempts to decrease market reliance on credit rating agencies and conflicts of interest and imposes a liability standard on the agencies.

This bill has been passed in the House and will be voted on in the Senate.

Newly Adopted SEC Rule Requires Disclosure of Money Market Fund Portfolio Holdings

On the heels of the expiration of the U.S. Treasury Department's Temporary Guarantee Program for Money Market Funds (Guarantee Program) (see description above), and in an effort to maintain greater transparency for shareholders about the risks inherent to investing in money market funds, the Securities and Exchange Commission (SEC) has adopted an interim final temporary rule under the Investment Company Act of 1940, as amended (Final Temporary Rule or the Rule).

The Final Temporary Rule, which became immediately effective on September 18, 2009, requires money market funds whose per share market-based net asset value (market-based NAV) falls below \$0.9975 to provide detailed weekly portfolio schedules and valuation information to the SEC. The Rule states that when a money market fund's market-based NAV first dips below \$0.9975, the fund is required to provide its portfolio schedule in Microsoft Excel format to the SEC by no later than the next business day. Every week thereafter that the money market fund's market-based NAV remains below \$0.9975, the fund must continue to report its portfolio schedule as of the last business day of each week to the SEC by no later than the second business day of the following week.

The Final Temporary Rule is scheduled to expire on September 17, 2010 and the SEC has asked for comments by October 26, 2009.

The Federal Trade Commission's "Red Flags Rule" Deadline Extended to June 1, 2010

On October 30, 2009, the Federal Trade Commission (FTC or Commission) extended the deadline for compliance with its Red Flags Rule (Rule) to June 1, 2010. According to the FTC, it is granting this extension at the request of members of Congress as it works toward finalizing legislation that would modify the applicability of the Rule. The FTC has also acknowledged that earlier that same day, the U.S. District Court for the District of Columbia ruled that the FTC may not apply the Rule to attorneys.

As discussed in earlier editions of the *Regulatory Administration Digest*, the Red Flags Rule stems from the Fair and Accurate Credit Transactions Act of 2003 and would 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. 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 (and enforcement of the Rule) was initially required by November 1, 2008 but was subsequently delayed to May 1, 2009, August 1, 2009 and November 1, 2009 and now to June 1, 2010.

The Commission staff continues to provide guidance to entities that may be affected by the Rule through materials posted on its website and in speeches and participation in seminars, conferences and other training events.

Supreme Court Hears Arguments in *Jones v. Harris* Case

On November 2, 2009, the U. S. Supreme Court heard arguments in the case of *Jones v. Harris Associates* (7th Circuit May 19, 2008), *cert granted*, (March 9, 2009), in which the petitioner contends that Harris Associates charged excessive investment advisory fees to shareholders of the registered investment company that it managed. The case is on review from a decision by the U. S. Court of Appeals for the 7th Circuit.

At issue in *Jones* is the interpretation of the standard for judicial review of excessive fee claims by investors against investment advisers under Section 36(b) of the Investment Company Act of 1940 (1940 Act). Congress enacted the 1940 Act to mitigate the conflicts of interest inherent in a relationship between investment advisers and the mutual funds they create and manage. In particular, Section 36(b) of the 1940 Act imposes on investment advisers “a fiduciary duty with respect to the receipt of compensation for services” and authorizes fund shareholders to bring claims for breach of those fiduciary duties. Furthermore, the 1940 Act provides that in such an action, approval by the board of directors of the fund is not conclusive, but shall be given consideration by the courts as deemed appropriate under the circumstances.

Previously, most courts relied upon the ruling in *Gartenberg v. Merrill Lynch Asset Management*, which determined that the test for deciding whether a fund adviser’s fees were excessive to the point of breaching its fiduciary duty was whether the fee was “so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” *Gartenberg* had been the prevailing standard for nearly 30 years until it was rejected in *Jones* by Chief Justice Frank Easterbrook of the 7th Circuit.

Justice Easterbrook ruled that absent the ability of the plaintiffs to prove that the fund advisers “played tricks” on the fund’s board of directors by withholding information, no fee being charged by advisers to investors could be deemed excessive. Easterbrook’s opinion reflected a free market approach, and he stressed that competitive pressures in the marketplace would help keep fund fees at a reasonable level. He noted that there are over 8,000 different mutual funds in the marketplace and that investments in any of these funds are easily redeemed. This, coupled with the fact that sophisticated investors take time to review and consider fund expenses thereby putting downward pressures on overall market fees paid to advisers, creates enough competitive pressure on the industry to overrule any inkling of an uncompetitive market. Easterbrook went on to state that investors can always “vote with their feet and dollars,” suggesting that if a shareholder was unhappy with the fees being charged by an investment adviser, they could easily leave that fund and invest in another with more reasonable fees.

Justice Easterbrook’s fellow jurist on the 7th Circuit, Justice Richard Posner, did not participate in the ruling, but Posner drafted a lengthy critique of Easterbrook’s opinion and



the assumptions used in its formulation. While a final decision is not expected until June 2010, observers believe the Supreme Court will take one of four actions: 1) uphold trial court's interpretation of *Gartenberg*, 2) remand the case back to the trials court and ask that they determine what constitutes a fair fee structure for mutual funds; 3) reinforce the current *Gartenberg* standard; or 4) accept the 7th Circuit's call for a stricter standard than *Gartenberg*.

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