

Financial Services Alert

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Developments of Note

➤ Department of Labor Administrative Law Judge Rules That Sarbanes-Oxley's Whistleblower Provisions Do Not Apply to Research Analysts of Privately Held Investment Adviser and Dismisses Suit

A Department of Labor Administrative Law Judge (the "Court") rendered an important decision holding that the whistleblower provisions of Section 806 of the Sarbanes-Oxley Act of 2002 ("SOX") do not apply to the employees of a privately held company providing investment advisory services to mutual funds, absent proof that the mutual funds' independent trustees or directors were involved in the employment decision at issue.

Plaintiff, a former research analyst, was fired for unsatisfactory performance. Two months later, he filed a SOX whistleblower complaint with the U.S. Department of Labor, claiming that his termination was due to his alleged whistleblowing activity. Plaintiff's former employer asserted several defenses, including that Section 806 of SOX does not apply to Plaintiff because he was employed by the privately held investment adviser, not by the publicly traded mutual funds to which the adviser provided advisory services.

Plaintiff argued that Section 806 of SOX covers the contractors and agents of publicly traded companies, and further that a privately held investment adviser and a mutual fund it advises should be considered an integrated enterprise/single employer. The Court permitted Plaintiff to engage in discovery on the SOX coverage issue and, following post-discovery briefing, which included extensive analysis of the legislative history of SOX and the history of the Investment Company Act of 1940 and the Investment Advisers Act of 1940, the Court agreed that SOX's whistleblower provisions do not apply to the employment decisions of privately owned contractors or agents of publicly traded companies (including mutual funds) unless they are acting at the direction or behest of such companies. The Court also declined to find that an investment adviser and a mutual fund it advises are an integrated

enterprise/single employer because the board of trustees of the mutual fund is controlled by a super-majority of independent trustees who have no affiliation with the investment adviser. Goodwin Procter LLP represented the investment adviser and the mutual funds in this matter.

➤ **SEC Staff Provides No-Action Relief to Permit Insurance Companies to Forego an SEC Substitution Order in the Case of Certain Mergers of Underlying Fund Investment Options**

The staff of the SEC's Office of Insurance Products of the Division of Investment Management took a no-action position permitting the insurance companies investing in an underlying fund not to seek a substitution order under Section 26(c) of the Investment Company Act of 1940, as amended (the "1940 Act"), when the underlying fund merged into another fund without any need for shareholder approval. Section 26(c) requires an insurance company issuing a variable annuity contract or a variable life insurance contract through a registered separate account to obtain an SEC order before it may substitute one underlying fund investment option for another underlying fund investment option. In a series of no-action letters in the 1980s and 1990s, the staff took the position that substitution orders were not required for fund mergers which, at the time, generally required shareholder approval. Since that time, state law changes have expanded the types of fund mergers that may be implemented without shareholder approval, and in 2002 the SEC adopted amendments to Rule 17a-8 under the 1940 Act to permit certain fund mergers without shareholder approval. For example, Rule 17a-8 does not require shareholder approval for a merger of two portfolios of the same series fund, where there are no material differences in fundamental investment policies, advisory contracts, or Rule 12b-1 fees.

The current relief was sought because fund reorganizations, even those that do not require shareholder approval, could be viewed as effecting a substitution requiring an order pursuant to Section 26(c). The no-action position taken by the SEC staff relieves insurance companies of any obligation to obtain a Section 26(c) order when a mutual fund they use as an investment option for their variable products merges into another mutual fund, provided certain conditions are met, including: (1) the merger meets all the conditions of Rule 17a-8; (2) the reorganization does not alter the contract owner's rights, or the insurance company's obligations, under the contracts; (3) the reorganization does not result in any tax liabilities to the contract owners; and (4) certain notifications are provided to the contract owners. Goodwin Procter represented the fund seeking the no-action relief.

➤ **FDIC Adopts Interim Final Policy Regarding the Treatment of Covered Bonds in a Conservatorship or Receivership**

The FDIC published an interim policy statement (the "Interim Policy Statement") to address uncertainties in the market for covered bonds. Covered bonds are mortgage-backed bonds that an insured depository institution ("DI") sells for purchase by investors or trusts. Unlike other mortgage-backed securities, however, the mortgages underlying the covered bonds remain on the bank's balance sheet.

Traditionally, parties in contract with a failed DI must wait up to 90 days before liquidating their collateral. This Interim Policy Statement reduces the collateral liquidation waiting period for holders of qualifying covered bonds. In order to qualify for expedited access to collateral, the covered bond must either be: (i) backed by pools of high-quality home mortgages underwritten at the fully indexed interest rate with full documentation of the borrowers' income, or (ii) backed by AAA-rated mortgage-backed securities collateralized solely by mortgages that would independently qualify under part (i) above, provided that the securities do not constitute more than 10% of the collateral for any bond issuance or series. Holders of qualifying covered bonds will be able to access bond collateral: (a) 10 days after a monetary default on an DI's obligation to the covered bond obligee, or (b) 10 days after the effective date of a written repudiation by the conservator or receiver. The Interim Policy Statement only applies to covered bonds issued with the consent of the DI's primary federal regulator. To prevent excessive change in the proportion of secured to unsecured liabilities on a DI's balance sheet, expedited collateral access is limited to qualifying covered bonds that comprise no more than 4% of the DI's total liabilities

after issuance. The Interim Policy Statement became effective on April 23, 2008, but will be open for public comment until June 23, 2008.

➤ **SEC Adopts Disclosure Requirements to Allow Registered Investment Companies to Rely on Protections Provided under the Sudan Accountability and Divestment Act of 2007**

The SEC adopted, substantially as proposed, amendments to Forms N-CSR and N-SAR that enable a registered investment company to rely on protections provided under the Sudan Accountability and Divestment Act of 2007 (the “Sudan Divestment Act”) when it divests from securities of issuers that it determines conduct or have direct investments in certain business operations in Sudan (“Sudan-Related Issuers”). The Sudan Divestment Act limits civil, criminal, and administrative actions that may be brought against a registered investment company that divests itself of securities of Sudan-Related Issuers, provided that the investment company makes disclosures in accordance with SEC rules.

Under the amendments, disclosure of a divestment would generally have to appear in the next report filed on Form N-CSR for mutual funds and other management investment companies, and in the next report filed on Form N-SAR for unit investment trusts. Form N-CSR is used to file shareholder reports and related certifications with the SEC, while semi-annual Form N-SAR filings provide the SEC with information on specified topics primarily related to a registered investment company’s financial statements; both forms are filed electronically and made publicly available on the SEC’s website.

A registered investment company that continues to hold any securities of an issuer whose securities are reflected in a Form N-CSR/N-SAR divestment disclosure must disclose certain information about that holding. The SEC’s proposal does not require a registered investment company to disclose divestments of securities of Sudan-Related Issuers; however, the protections of the Sudan Divestment Act do not apply to a divestment that is not disclosed. The form amendments are effective April 30, 2008. The amendments include a transition provision for situations where a fund has (a) made a divestment after the Act’s December 31, 2007 enactment date but before April 30, 2008 and (b) filed a Form N-CSR or N-SAR after the divestment but before April 30, 2008; under those circumstances, the fund could rely on the safe harbor for the divestment if it filed a revised Form N-CSR or N-SAR that disclosed the divestment in accordance with the form amendments no later than May 14, 2008.

Other Items of Note

➤ **FINRA Files Proposal to Delay May 5 Effective Date of Portions of New Rule Governing Deferred Variable Annuity Sales and Exchanges**

The Financial Industry Regulatory Authority (“FINRA”) has submitted a filing to the SEC seeking to delay the May 5, 2008 effective date for paragraphs (c) (principal review) and (d) (supervisory procedures) of new NASD Rule 2821, which establishes suitability, supervisory and training requirements for sales and exchanges of deferred variable annuities. (The Rule’s requirements were summarized in the September 18, 2007 *Alert*; FINRA Regulatory Notice 07-53 (November 2007) announcing the Rule’s effective date and providing interpretive guidance was summarized in the November 20, 2007 *Alert*.) FINRA’s filing proposes that the SEC delay the effective date of paragraphs (c) and (d) of the Rule until 180 days after the SEC either approves or rejects the substantive changes to the Rule FINRA intends to propose in the near future in a separate filing. FINRA plans to propose changing the event that triggers the beginning of the period within which a principal must review and determine whether to approve or reject a customer’s application for a deferred variable annuity. FINRA also intends to propose limiting the Rule’s application to recommended transactions. Finally, FINRA plans to clarify various other issues, including whether (and, if so, under what circumstances) a broker-dealer can forward funds to an affiliated insurance company prior to principal approval. FINRA’s filing seeking to delay the effective date of paragraphs (c) and (d) of the Rule notes that paragraphs (a), (b), and (e) of the Rule will become effective as scheduled on May 5, 2008.

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➤ **SEC Posts Overview of Voluntary Data Tagging Program for Mutual Funds**

The SEC has posted on its website a brief overview that summarizes and explains rules adopted by the SEC in implementing its voluntary program to permit mutual funds to submit data tagged prospectus risk/return summary information in EDGAR filings. Data tagging labels information in electronic filings using standardized definitions so that the information can be retrieved, searched and analyzed through automated means. The newly posted summary provides a straightforward overview of the kinds of information subject to tagging, the practical details of submitting tagged information in EDGAR filings and resources for more detailed information on the voluntary program. The SEC is promoting data tagging to increase ability of investors, analysts and others to collect and use information in disclosure documents filed with the SEC. The SEC recently unveiled a mutual fund comparison tool on its website that demonstrates the use of data tagged information extracted from filings made by mutual funds participating in the voluntary program (*see* the April 15, 2008 *Alert*).