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# Financial Services Alert

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**New Subscribers, Past Issues and Background**

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expressed only his view and not necessarily those of his fellow SEC Commissioners or the President. In 2006, the SEC issued a major interpretive release addressing soft dollars (*see* the July 25, 2006 *Alert*). Various SEC Commissioners and members of the SEC staff have since indicated that additional soft dollar guidance may be forthcoming. The SEC's March 2, 2007 Semi-Annual Regulatory Agenda, which is discussed elsewhere in this issue, includes an item discussing proposed rulemaking that would require an investment adviser to "create a report and maintain records regarding [its] direction of brokerage transactions and receipt of research and other services in connection with those transactions."

### **¾ NASD and NYSE File Proposed Rules Addressing Business Entertainment Oversight**

The SEC published for notice and comment proposed rule changes filed by the NASD and the NYSE setting forth requirements applicable to the provision of business entertainment by members and their associated persons to representatives of the members' customers. The proposed NASD rule change would be set forth in an Interpretive Material to NASD Rule 3060, and the proposed NYSE rule change would be implemented as new NYSE Rule 350 (collectively, the "rule changes"). Both rule changes seek to address the potential conflicts of interest raised by business entertainment and related activities, which are not currently covered under either regulatory organization's "gift" rule, using a principles-based approach under which members must develop firm-specific standards implementing the general requirements of the rule changes. The NASD and NYSE have requested an effective date of six months following SEC approval in order to give their members sufficient time to upgrade systems and develop procedures to effectively comply with the rule changes' requirements. The NASD and NYSE indicated in their filings that they intend to issue a Notice to Members and Information Memo, respectively, announcing each rule change's compliance deadline following SEC approval.

With one significant exception, as discussed in greater detail below, the proposed NASD and NYSE rule changes are substantially similar. Both the rule changes define the specific business entertainment covered and require members to adopt and implement written policies and procedures governing their business entertainment, maintain detailed records of business entertainment expenses and provide each customer with business entertainment records relating to its customer representatives upon request. The rule changes require members to determine and define which forms of business entertainment are appropriate and inappropriate using quantitative and qualitative standards that address the nature and frequency of the business entertainment provided, as well as the types and class of any accommodations or transportation that may be provided attendant to such entertainment. The rule changes also require members to either impose specific dollar limits on business entertainment or require written pre-approval of any entertainment that exceeds a specified dollar threshold. Consistent with their principles-based approach, neither rule change specifies what those dollar limits or thresholds should be.

Both rule changes define the terms "customer," "customer representative" and "business entertainment", but solely for purposes of the rule changes. "Customer" is defined as a "person that maintains a business relationship with a member [firm/organization] via the maintenance of an account, through the conduct of investment banking, or pursuant to other securities-related activity" or "a person whose customer representative receives business entertainment for the purpose of encouraging such person to establish a business relationship with a member organization by opening an account with the member [firm/organization] or by conducting investment banking or other securities-related activity with the member [firm/organization]." A "customer representative" is a person (other than certain customer family members) who is a customer's employee, officer, director or agent. (Because the rule changes target business entertainment provided to customer representatives they do not address business entertainment provided directly to natural person customers.) "Business entertainment" is defined so that, absent exigent circumstances (which must be documented), a member must accompany the customer representative to, or participate in, an event for it to be deemed business entertainment rather than a gift.

The rule changes require each member to specify the methodology for calculating the value of business entertainment and requires that business entertainment expenses generally be valued at the higher of

face value or cost to the member. In addition, the rule changes require that members' written policies and procedures include procedures designed to detect and prevent business entertainment that is intended as, or could reasonably be perceived to be intended as, an improper *quid pro quo*, or could otherwise give rise to a potential conflict of interest. The rule changes require members to maintain detailed records of business entertainment expenses and make such information available to each customer with respect to its customer representatives upon written request. The rule changes include an express exception from their recordkeeping requirements for expenses under \$50 and limited exemptions from certain other provisions for any member whose business entertainment expenses in the course of its fiscal year are below \$7,500. With respect to the recordkeeping exception for expenses under \$50, the rule changes require members to implement policies and procedures designed to prevent their associated persons from circumventing the recordkeeping requirements, for example, by routinely providing entertainment that falls just below the \$50 limit. Under the rule changes, members' business entertainment policies and procedures would have to provide for effective supervision of, and appropriate education and training for, all personnel who supervise, administer or are subject to those policies and procedures.

As mentioned above, the NYSE rule change contains one significant additional provision not contained in the NASD rule change. Specifically, under the NYSE rule change each member must have a system in place to give notice (via the member's website, a disclosure document, or other appropriate means) to customers that, upon their written request, the member will promptly provide detailed information regarding any business entertainment it provided to their respective customer representative(s). In its filing with the SEC, the NYSE stated that it believes this provision would encourage the expansion of monitoring and controls on business entertainment by customers of member firms.

### **¾ Review of SEC's Semi-Annual Regulatory Agenda**

The SEC published its Semiannual Regulatory Agenda (the "Agenda") which, in compliance with the Regulatory Flexibility Act, identifies anticipated rulemaking activities that are likely to have a significant economic impact on a substantial number of small entities. The Agenda speaks as of March 2, 2007. Publication of the Agenda does not preclude the SEC from considering, or acting on, other matters. Nor is the SEC required to act on matters that appear in the Agenda, or, as events since the issuance of the Agenda have borne out, act on matters included in the Agenda in the indicated timeframes. Given the timing targets that have been missed to date, the dates provided in the Agenda are probably not a very reliable indicator of when the SEC will act on these initiatives. Nevertheless, the Agenda does give an indication of where SEC rulemaking priorities may lie. Described below are a number of rulemaking initiatives discussed in the Agenda that are likely to affect the investment management industry.

#### **EXISTING INITIATIVES**

*Universal Internet Availability of Proxy Materials.* In December 2005, the SEC proposed amendments to require proxy materials to be made available online. This proposal (discussed in the January 30, 2006 *Alert*) coincided with the adoption of final rule amendments that allow issuers to satisfy the requirements for delivering proxy materials under Rule 14a-3 of the Securities Exchange Act of 1934 (the "1934 Act") by making them available online. The Agenda indicates that the SEC plans to take final action on this proposal in September 2007.

*Security Holder Director Nominations.* In July 2003, the SEC proposed to amend its proxy rules to require that under certain circumstances an issuer's proxy materials must include: (a) the name(s) of a person(s) nominated by a security holder or group of security holders for election to the board of directors, (b) certain disclosure about the nominee or nominees and the nominating security holder or holders, and (c) in certain instances, a statement of support for the security holder nominee or nominees (*see* the October 21, 2003 *Alert*). The Agenda indicates that final action on this proposal is expected in November 2007.

*Definition of Securities “Held of Record.”* The Division of Corporation Finance is withdrawing from the Agenda an item under which it would have proposed revisions of the definition of “holders of record” in the 1934 Act Rule 12g5-1, which exempts from registration under the 1934 Act a security with less than 500 holders of record. The proposed change would have treated the beneficial owners of securities registered in the name of a broker, dealer or bank as holders of record, thus making it more difficult in some cases to satisfy on the Rule 12g5-1 exemption.

*Political Contributions by Certain Investment Advisers.* The Agenda indicates that the SEC is planning to seek further comment on its 1999 proposal to prohibit investment advisers from engaging in so-called “pay to play” practices. The rule proposed in 1999 would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or any of its partners, executive officers, or solicitors makes a contribution to certain elected officials or candidates. The proposed rule would also require a registered adviser that has government clients to maintain certain records of the political contributions made by the adviser or any of its partners, executive officers, or solicitors. The Agenda indicates that a further rulemaking proposal is expected in September 2007.

*Investment Company Portfolio Transaction Costs.* In a December 2003 concept release, the Commission sought public comment on ways to improve disclosure of mutual fund portfolio transaction costs (*see* the December 30, 2003 *Alert*). The Division of Investment Management is considering whether to recommend to the Commission amendments to investment company registration statement disclosure requirements in this area. The Agenda indicates that a rulemaking proposal is expected in September 2007.

*Model Privacy Notice.* The Commission and several other federal agencies are considering whether to permit or require financial institutions to provide alternative types of privacy notices in compliance with Title V of the Gramm-Leach-Bliley Act. In March 2006, an Interagency model privacy notice was issued for public comment (*see* the March 27, 2007 *Alert*). The Agenda indicates that final action on this proposal is expected in December 2007.

*Investment Company Governance.* In June 2005, the U.S. Court of Appeals for the District of Columbia vacated rule amendments under the Investment Company Act of 1940, as amended (the “1940 Act”), that required registered investment companies (“funds”) relying on certain designated exemptive rules under the 1940 Act to have an independent chairman of the board and a board of directors consisting of no less than 75% independent directors. The Court remanded the matter to the SEC, staying its mandate to allow the SEC to reopen the rulemaking record (*see* the June 28, 2005 *Alert*). In June 2006, the Commission requested additional comment regarding the fund governance provisions (*see* the June 20, 2006 *Alert*). In December 2006, the Commission reopened the comment period on its June 2006 request for comment in order to permit public comment on two papers prepared by the Office of Economic Analysis (*see* the December 19, 2006 *Alert*). The Agenda indicates that a supplemental rulemaking proposal is expected in August 2007.

*Amendments to Form ADV.* The Division of Investment Management is considering recommending that the Commission seek further public comment regarding proposed amendments to Part II of Form ADV under the Investment Advisers Act of 1940, as amended (the “Advisers Act”). In September 2000, the Commission adopted amendments to Part I of Form ADV, including an electronic filing system for Form ADV, but deferred final action on proposed amendments to Part II of Form ADV (*see* the September 19, 2000 *Alert*). The Agenda indicates that the SEC expected to take further rulemaking action in May 2007, with final action regarding the amendment expected in December 2007.

*Prohibition of Fraud by Advisers With Respect to Certain Pooled Investment Goodwin Procter Vehicles and New Category of Accredited Investors for Certain Private Investment Vehicles.* Following a successful court challenge to SEC rulemaking designed to result in the registration of hedge fund advisers (*see* the June 27, 2006 *Alert*), the SEC proposed new rules directed at advisers of private

investment funds (*see* the Goodwin Procter Hedge Fund Alert dated January 8, 2007). The first proposal targets fraudulent statements and actions of investment advisers with respect to investors and prospective investors in certain pooled investment vehicles. The second proposal would increase the minimum qualifications that natural person investors in certain private funds must satisfy to be treated as “accredited investors” for purposes of the Regulation D exemption from registration available to the private funds under the Securities Act of 1933, as amended. The Agenda indicates that final action regarding the proposals is expected in July 2007.

*Exemption from Shareholder Approval for Certain Sub-Advisory Contracts.* In October 2003, the Commission proposed a new rule that would allow certain types of funds or their investment advisers to enter into sub-advisory agreements for investment management services without obtaining shareholder approval (*see* the October 28, 2003 Alert). The Agenda indicates that final action regarding the proposal is expected this month.

*Amendments to Rules Governing Pricing of Mutual Fund Shares.* In October 2003, the Commission proposed amendments to Rule 22c-1 under the 1940 Act designed to address late trading and abusive market timing activities (*see* the December 16, 2003 Alert). Under the proposed amendment, an order to purchase or redeem mutual fund shares would receive the current day’s price only if the fund, its designated transfer agents, or a registered securities clearing agency received the order by the time the fund has established for calculating its net asset value. The Agenda indicates that a final action regarding the proposal is expected this month.

*Extension of XBRL Voluntary Reporting Program on the EDGAR System to Mutual Fund Risk/Return Summary Information.* In February 2007, the Commission proposed to expand the current Voluntary Financial Reporting Program on the EDGAR System to allow open-end management investment company filers to voluntarily furnish the Risk/Return Summary information in mutual fund prospectuses in XBRL format (*see* the February 6, 2007 Alert). XBRL is a syntax that permits tagging of standardized data in disclosure documents. XBRL tagged data on EDGAR can be retrieved, searched and analyzed through automated means such as Microsoft Excel spreadsheets. The Agenda indicates that a final action on the proposal is expected this month.

*Amendments to Investment Company Registration Statements to Protect Certain Private Information.* The Division of Investment Management is withdrawing from the Agenda a proposal to modify disclosure requirements in order to safeguard the privacy interests of investors qualifying as principal holders of a class of securities of certain investment companies. The Agenda indicates that the Division of Investment Management does not expect the Commission to consider this item in the next 12 months, but the Commission may consider it at a later date.

*Bank Exceptions from the Definitions of Broker and Dealer under the 1934 Act.* The Commission, in conjunction with the Board of Governors of the Federal Reserve System, proposed rules designed to define and clarify the statutory exceptions from the definition of “broker” and “dealer” under the 1934 Act and grant banks new conditional exemptions from the “broker” definition (*see* the December 19, 2006 Alert). The Agenda indicates that an interim final rule is expected in July 2007.

## **NEW INITIATIVES**

*Books and Records to be Maintained by Investment Advisers.* The Division of Investment Management is considering recommending that the Commission update the books and records requirements for registered investment advisers under the Advisers Act. The Agenda indicates that a rulemaking proposal is expected in December 2007.

*Disclosure and Recordkeeping Requirements for Investment Advisers Regarding Brokerage Allocation and Soft Dollar Practices.* The Division of Investment Management is considering recommending that the Commission propose rules that would require investment advisers to create a report and maintain

records regarding their direction of brokerage transactions and receipt of research and other services in connection with those transactions. The Agenda indicates that a rulemaking proposal is expected in October 2007.

*Exchange Traded Funds.* The Division of Investment Management is considering recommending that the Commission propose new rules and rule amendments to codify prior exemptive relief granted for index-based exchange traded funds. The Agenda indicates that a rulemaking proposal is expected this month.

*Definition of "Issued Ratably" Under Section 18(d) of the Investment Company Act of 1940.* The Division of Investment Management is considering recommending that the Commission propose new Rule 18(d)-1, which would define the term "issued ratably" used in Section 18(d) of the Act. Section 18(d) of the Investment Company Act prohibits a registered fund from issuing any warrant or right to subscribe to the fund's securities, unless the warrant or right expires not later than 120 days after its issuance and is issued exclusively and ratably to a class or classes of the fund's security holders. The Agenda indicates that a rulemaking proposal is expected in August 2007.

*Investment Company Disclosure Reform.* The Division of Investment Management is considering recommending that the Commission issue a release proposing comprehensive reforms to the disclosure requirements of Form N-1A for mutual funds. The proposed changes would include streamlining delivery of mutual fund information through increased use of the internet and other electronic means of delivery and clarifying the disclosure of fees and expenses for mutual funds and exchange traded funds. The Agenda indicates that a rulemaking proposal is expected this month.

*Frequency of Distribution of Capital Gains.* The Division of Investment Management is considering recommending that the Commission propose amendments to rules governing dividend payments and distributions by registered investment companies pursuant to Section 19 of the 1940 Act. Section 19(a) requires a registered investment company to disclose the source of a dividend or distribution that is not made from net income. Currently, Rule 19a-1 generally prescribes the form of that disclosure and Rule 19b-1 limits the frequency with which long-term capital gains may be distributed to not more than once a year subject to certain limited exceptions. The Agenda indicates that a rulemaking proposal was expected in May 2007.

*Mandatory Electronic Submission of Exemptive Applications Under the 1940 Act.* The Division of Investment is considering recommending that the Commission propose rules for mandatory EDGAR submission of exemptive and other applications under the 1940 Act, as well as minor technical corrections to the electronic filing rules. The Agenda indicates that a rulemaking proposal was expected in May 2007.

*Fund of Funds Investments.* The Division of Investment Management is considering recommending that the Commission propose amendments to the exemptive rules under the 1940 Act that permit one fund to invest in other funds. In 2006, the Commission adopted new exemptive rules related to funds of funds to permit certain cash sweep arrangements and to expand the statutory exemptions for funds of funds that invest in affiliated funds and those that invest in unaffiliated funds (*see* the June 27, 2006 *Alert*). The Agenda does not specify the nature of the anticipated proposal. The Agenda indicates that a rulemaking proposal is expected in December 2007.

*Custody of Securities with Members of National Securities Exchanges and Registered Management Investment Companies.* The Division of Investment Management is considering recommending that the Commission propose amendments to the rules under the 1940 Act that govern investment companies' use of members of national securities exchanges and registered management investment companies as custodians. The Agenda indicates that a rulemaking proposal is expected in November 2007.

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*Amendments to the Cash Solicitation Rule.* The Division of Investment is considering recommending that the Commission propose amendments to update and modernize Rule 206(4)-3 under the Advisers Act governing cash payments by registered investment advisers to solicitors. The Agenda indicates that a rulemaking proposal is expected in March 2008.

*Definition of "Equal Voting Rights" under Section 18(i) of the 1940 Act.* The Division of Investment Management is considering recommending that the Commission propose Rule 18i-1 under the 1940 Act, which would define the term "equal voting rights" in Section 18(i) of the Act. Section 18(i) requires each share of a registered management investment company's stock to have equal voting rights with every other share. The Agenda indicates that a rulemaking proposal is expected in August 2007.

*Employees' Security Company.* The Division of Investment Management is considering recommending that the Commission propose a rule under the 1940 Act to codify certain exemptions the Commission has granted to employees' security companies. The Agenda indicates that a rulemaking proposal is expected in March 2008.

*Point-of-Sale Disclosure for Mutual Fund, Unit Investment Trust and 529 Plan Sales.* In 2005, the Commission proposed new rules under the 1934 Act that would require certain confirmation and pre-transaction "point of sale" disclosure of distribution costs and conflicts of interest associated with transactions in mutual funds, unit investment trusts and municipal fund securities (often referred to as 529 Plans). The Agenda indicates that a further rulemaking proposal is expected this month.