

Financial Services Alert

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Developments of Note

➤ Staff of SEC's Division of Investment Management Issues Q&A Regarding Disclosure of Expenses of Investing in Other Funds in Prospectus Fee Tables

The staff of the SEC's Division of Investment Management provided guidance in a question and answer format (the "Q&A") regarding issues raised regarding the new prospectus fee table disclosure requirements under which certain registered funds must disclose as a separate line item in their fee tables the expenses of investing in other funds. The new disclosure requirements, which were adopted as part of rule amendments addressing cash sweeps by registered funds and the conditions applicable to registered affiliated and unaffiliated funds-of-funds (see the June 27, 2006 *Alert*), apply to the prospectus fee tables for open-end investment companies, closed-end investment companies, and separate accounts organized as management investment companies. (The new fee table disclosure applies to filings on or after January 2, 2007 that are either (a) new registration statements or (b) post-effective amendments that are annual updates.) The Q&A covers a range of questions from technical expense calculation issues to the types of underlying fund investments that fall within the disclosure requirement. In the latter category, the Q&A notes that fees and expenses associated with investing cash collateral from securities lending activity in a money market fund or other cash sweep vehicle would not trigger the new disclosure requirements.

➤ FRB Proposes Regulation Z Amendments

The FRB announced a long-awaited proposal to amend Regulation Z's open-end credit provisions. Focusing mainly on credit card transactions, the proposal is aimed at making disclosures more understandable to consumers. The lengthy proposal, which does not apply to home equity lines of credit, contains recommendations to address formatting, timing, and content for a wide variety of required disclosures, including expanded Schumer boxes to enhance clarity and to summarize key terms, and modified periodic statements to group like charges together, itemize interest charges for different types of transactions, and provide dollar amounts of fees along with percentages. For example, under the proposal, the Schumer box (which is currently a table of statements describing the account) may be modified by using numeric figures instead of text in some instances in order to make the disclosure easier to understand. The proposal requests input on modified terminology requirements to make the "effective APR" more understandable to consumers, and asks for comment on whether this disclosure should be eliminated altogether. Additionally, the proposal would require 45 days advance notice—replacing today's 15 day requirement—before a creditor can impose certain changes in terms

or rate increases due to delinquency or default. This review is the first by the FRB to incorporate extensive consumer testing into its rulemaking recommendations. Comments on the proposal must be received within 120 days of the proposal's publication in the *Federal Register*. The proposal may be found at <http://www.federalreserve.gov/BoardDocs/Press/bcreg/2007/20070523/default.htm>. Comments may be submitted at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.

➤ Federal Court of Appeals for 7th Circuit Reverses District Court Injunction Requiring Consumer Products and Munitions Company to Register as Investment Company

The United States Court of Appeals for the Seventh Circuit (the "Court") reversed a decision by the United States District Court for the Northern District of Illinois (the "District Court") that required a consumer products and munitions company to register as an investment company. The SEC had sought the District Court injunction after determining that the company met the definition of "investment company" under Section 3(a)(1)(C) of the Investment Company Act of 1940, as amended (the "1940 Act"), which provides that an issuer is an investment company if it is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of its total assets (exclusive of certain government securities and cash items) on an unconsolidated basis. The company had come to have a significant portion of its assets in financial instruments as a result of divesting its manufacturing facilities in favor of subcontracting production to third parties and the closure of one of its munitions facilities.

The District Court Injunction. The SEC filed suit in the District Court seeking to compel the company to register as an investment company under the 1940 Act, restructure its holdings to avoid the Act's requirements or otherwise comply with the 1940 Act. The District Court ruled in the SEC's favor and issued an injunction requiring the company to register as an investment company. (In so doing, the District Court disregarded additional elements of the SEC's proposed relief, which would have allowed the company to file for exemptive relief from the 1940 Act's requirements, or allowed the company to replace enough of its securities portfolio with government securities and cash items to fall short of the 40% threshold in Section 3(a)(1)(C). The company had already taken the latter step when the Court issued the injunction.)

Consequences of the District Court Injunction. Following the injunction, the company's auditor resigned and refused to provide consents to allow the company to use the financial statements the firm audited for any purpose. As a consequence, the company could not comply with the periodic reporting requirements of either the 1940 Act or the Securities Exchange Act of 1934, as amended. The company's failure to comply with financial reporting requirements under the securities laws and under its listing agreement with the New York Stock Exchange caused the Exchange to take steps towards delisting the company's stock. The company continued to refuse to submit an application to the SEC requesting exemptive relief although the Court observed that the Commission's counsel had implied in oral argument that an exemption would be granted. (Although not referenced in the Court's opinion, the company did file an application for deregistration as an investment company shortly after filing the notification of registration as an investment company and 1940 Act registration statement necessary to comply with the injunction.)

The Court's Analysis. The Court found no merit in the company's arguments that its holdings of refunded municipal securities and variable rate demand notes could be treated as government securities and cash items, respectively, thus reducing the amount of the company's securities holdings counted toward the 40% threshold to a level that would bring it outside the ambit of Section 3(a)(1)(C). The Court then turned to the question of whether the company could avail itself of Section 3(b)(1) of the 1940 Act, which provides that an issuer that falls with Section 3(a)(1)(C) is nevertheless not an investment company if the issuer is primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding or trading in securities.

Tonopah Factors. Noting that neither the 1940 Act nor its rules defined the term “primarily” in Section 3(b)(1), the Court turned to the factors set forth by the SEC in *In re Tonopah Mining Co.*, 26 S.E.C. 426 (1947) (“*Tonopah*”) to determine whether or not the company had become what is generally referred to as an “inadvertent investment company.” Those factors were as follows: (a) the enterprise’s history, (b) the way the enterprise represents itself to the investing public today, (c) the activities of its officers and directors, (d) the nature of its assets and (e) the sources of its income.

The Court began its analysis by examining the company’s history, noting that the company was an active manufacturer of industrial, consumer and military products until the 1980s, when it started to subcontract manufacturing activities, and remained an active manufacturer of absorbent goods and military ordnance in addition to selling a line of kitchen goods under its own trademark. The Court contrasted the company’s situation with that of two frequently cited examples of inadvertent investment companies – the mining company at issue in *Tonopah* and the bus company at issue in *SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968), affirmed, 435 F.2d 510 (2d Cir. 1970) (“*Fifth Avenue*”). The Court observed that these firms had sold all or almost all of their assets, reduced their operations to a skeleton staff and purported to be looking for acquisitions but never seemed to find them. This was in contrast to what the Court described as the company’s “substantial ongoing presence in product markets.” Turning to the second *Tonopah* factor, the Court found that the company presented itself to the public and to investors as an operating company, on its website and in its annual reports and publicity, in contrast to the firms in *Tonopah* and *Fifth Avenue*. The Court found that the *Tonopah* factor addressing officers’ and directors’ activities also favored the company’s position noting that the company had estimated that 90% of its managers’ time was devoted to running its consumer products and ordnance businesses, and that the SEC had not offered any contrary evidence.

In addressing the fifth *Tonopah* factor, the Court looked at both gross and net income, finding that the company’s gross income was dominated by receipts from its sales activities which generated more than 90% of gross receipts for each year covered by the record. With respect to net income, the SEC calculated that over the decade covered by the record, 50.22% of the company’s net profits were derived from investments in securities, while the company’s calculations indicated that operating profits exceeded investment profits for the decade as a whole. The SEC acknowledged, however, that in each of the three years immediately preceding the District Court’s injunction, less than 40% of the company’s net profit was from investments. The Court concluded that the net income information from earlier periods was not relevant at the time of the District Court injunction and that the company’s net income figures at that time did not support the finding that the company was an investment company. The Court again contrasted the company’s situation with that of the mining company in *Tonopah* where the SEC found that “the company’s only source of net income consisted of interest, dividends and profits on the sale of securities; and we find nothing to indicate that this situation will be changed substantially in the foreseeable future.”

On the fourth *Tonopah* factor, the nature of the company’s assets, the Court disagreed with the SEC’s contention that this was the most important of the five factors. More than 60% of the company’s assets were investment securities during every year covered by the record. The Court reasoned that the SEC’s emphasis on the assets factor was inconsistent with the exception from investment company status provided by Section 3(b)(1) of the 1940 Act, and the SEC’s past positions in this area. As a matter of statutory construction, the Court found that it was not rational to conclude that in looking to whether an issuer is “primarily engaged” in non-investment company activities under Section 3(b)(1) that Congress intended merely to establish a higher threshold than the 40% test an issuer had already failed in order to fall within Section 3(a)(1)(C). The Court concluded that the inquiry under Section 3(b)(1) had to be about considerations other than assets (or at least in addition to assets). The Court went on to find that the SEC had previously taken this position in *Tonopah* where it indicated, “what principally matters [in this inquiry] is the beliefs the company is likely to induce in investors. Will its portfolio and activities lead investors to treat a firm as an investment vehicle or as an operating enterprise?” The Court observed that the SEC had not subsequently altered this view through rulemaking or administrative adjudication, and could not permissibly do so via briefs filed in this case. The Court concluded its analysis by finding that reasonable investors would treat the company as an operating company rather

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than a competitor with a closed-end fund, that the SEC had not tried to demonstrate anything different about investors' perceptions or behavior, and that it therefore followed that the company was not an investment company. The Court reversed the judgment of the District Court and indicated that the company was free to drop its 1940 Act registration whether or not the SEC formally approved that action.

Other Item of Note

➤ **SEC Announces Roundtable Discussion Regarding Rule 12b-1 under the Investment Company Act**

The SEC issued a press release announcing that it will host a June 19, 2007 roundtable discussion on issues related to Rule 12b-1 under the Investment Company Act of 1940, as amended. Rule 12b-1 allows a mutual fund to use its assets to finance distribution of its shares, provided certain conditions are met. The roundtable will consist of panels addressing the following topics: the circumstances that prompted Rule 12b-1's adoption, and the Rule's original intended purpose; how the uses of Rule 12b-1 have evolved and the Rule's current role in fund distribution practices; the costs and benefits of the manner in which Rule 12b-1 is currently used; and the options for the Rule's reform or rescission. The SEC will publish a final agenda and list of participants and moderators closer to the date of the roundtable. The SEC indicated that it welcomes public comment on the roundtable topics, and will provide a list of specific issues it would like the public to address.