

# Financial Services Alert

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## *Developments of Note*

### ➤ **IOSCO Publishes Final Report on Hedge Fund Portfolio Valuation Principles**

The Technical Committee (the "Committee") of the International Organization of Securities Commissions ("IOSCO") published a final report (the "Final Report") recommending a single, global set of principles relating to the valuation of the financial instruments employed or held by hedge funds (the "Principles") and discussing the application of the Principles in developing and implementing comprehensive policies and procedures for valuation of hedge fund portfolios. The Principles were originally proposed in a Consultation Report issued by the Committee on March 8, 2007 (the "Consultation Report") as discussed in the April 3, 2007 issue of the *Alert*.

The Final Report indicates that the goal of the Principles is to seek to ensure that a hedge fund's financial instruments are appropriately valued and, in particular, that those values are not distorted to the disadvantage of fund investors. The Final Report notes that the Committee received comments on the Consultation Report from several interested parties across the industry. These comments were generally favorable and consisted primarily of requests for clarification on how to apply the Principles. Based on the positive response to the Principles and the lack of substantive objection, the Committee published the Final Report largely unchanged from the Consultation Report and with no substantive changes to the Principles themselves.

The Principles are designed to be applicable across a wide range of jurisdictions, as well as a number of different hedge fund and service provider structures. The nine Principles as recommended in the Final Report are as follows:

1. Comprehensive, documented policies and procedures should be established for the valuation of financial instruments held or employed by a hedge fund.
2. The policies should identify the methodologies that will be used for valuing each type of the financial instruments held or employed by the hedge fund.

3. The financial instruments held or employed by hedge funds should be consistently valued according to the policies and procedures.
4. The policies and procedures should be reviewed periodically to seek to ensure their continued appropriateness.
5. A hedge fund's governing body should seek to ensure that an appropriately high level of independence is brought to bear in the application of the policies and procedures and whenever they are reviewed.
6. The policies and procedures should seek to ensure that an appropriate level of independent review is undertaken of each individual valuation and in particular of any valuation that is influenced by the hedge fund's investment manager.
7. A hedge fund's policies and procedures should describe the process for handling and documenting price overrides, including the review of price overrides by an independent party (which may be a separate group within the investment manager's organization).
8. A hedge fund's governing body should conduct initial and periodic due diligence on third parties that are appointed to perform valuation services.
9. The arrangements in place for the valuation of the hedge fund's investment portfolio should be transparent to investors.

#### ➤ Agencies Issue Proposed Rules and Guidelines that Address Accuracy and Integrity of Consumer Report Information and Rules to Allow Direct Disputes

The federal bank regulatory agencies and the Federal Trade Commission (the "Agencies") approved proposed regulations and guidelines to help ensure the accuracy and integrity of information provided to consumer reporting agencies and to allow consumers to dispute inaccuracies directly with financial institutions and other entities that furnish information about consumers to consumer reporting agencies ("furnishers"). Public comment is requested by the Agencies on any aspect of the proposed rules and guidelines. There will be a 60-day comment period after the proposal's publication in the *Federal Register*.

The proposed rules have three components. The first component – the proposed accuracy and integrity regulations – would require a furnisher to establish and implement reasonable written policies and procedures regarding the accuracy and integrity of the information about consumers that it provides to a consumer reporting agency. The second component of the proposed rules – the proposed accuracy and integrity guidelines – would set out the objectives that the policies and procedures should reasonably be designed to achieve, as well as the requirements of the Fair Credit Reporting Act that the policies and procedures should address. These guidelines furthermore would identify steps furnishers should follow when establishing accuracy and integrity policies and procedures and would detail specific components that should be addressed in a furnisher's policies and procedures. The third component of the proposed rules – the direct dispute regulations – would identify the circumstances under which a furnisher would be required to reinvestigate a dispute concerning the accuracy of information contained in a consumer report, based on a direct request by the consumer. The proposed rule is designed to permit direct disputes in virtually all circumstances involving disputes with respect to the types of information typically provided by the furnisher to a consumer reporting agency, while excepting out certain types of information from the direct dispute process. For example, a furnisher would not be required to investigate a dispute that a furnisher reasonably determines to be frivolous or irrelevant.

The Agencies also seek comment on two alternative approaches to defining the terms "accuracy" and "integrity" in the text of the regulations and guidelines. Under the first approach, the "Regulatory Definition Approach," the Agencies would provide specific definitions for the terms "accuracy" and "integrity" in the regulations, and the accuracy and integrity guidelines would reflect the regulatory definitions of "accuracy" and "integrity." The alternative approach, the "Guidelines Definition

Approach,” would define these terms in the guidelines, rather than in the regulations, with reference to the objectives that a furnisher’s policies and procedures should be designed to accomplish.

➤ **Massachusetts Securities Division Files Administrative Complaint against Hedge Fund Adviser over Compliance with Approval Process for Hedge Fund Transactions with Adviser Affiliates and other Adviser Sponsored Vehicles**

The Massachusetts Securities Division in the Office of the Secretary of the Commonwealth (the “Division”) filed an administrative complaint (the “Complaint”) against a federally registered investment adviser (the “Adviser”) over the implementation of procedures designed to address potential conflicts of interest in transactions between two hedge funds sponsored and managed by the Adviser on the one hand and on the other hand, a broker-dealer affiliate of the Adviser serving as a prime broker and various special purpose and other vehicles structured by the Adviser. The funds in question filed for bankruptcy during June and July 2007. This article summarizes some of the principal allegations in the Division’s lengthy and detailed Complaint, which covers events that took place between 2003 and 2007.

The Division’s allegations focus primarily on disclosures in the offering documents for one of the hedge funds, and the implementation of procedures for approving (1) transactions that involved the purchase or sale by the master fund in which the hedge fund invested (both vehicles being referred to as the “Fund”) of a security that was subject to Section 206(3) of the Investment Advisers Act of 1940, as amended (the “Advisers Act”), and (2) transactions between the Fund and the Adviser or its affiliates involving “significant conflicts of interest (including principal trades)” (all of the foregoing transactions being collectively referred to as “Related Party Transactions”). (In general terms, Section 206(3) of the Advisers Act prohibits transactions between a federally registered investment adviser (and certain of its affiliates) on one hand and a client of that adviser on the other hand, absent the client’s informed prior consent following disclosure of the capacity in which the adviser acted.) The Fund’s offering document disclosures indicated that for each of the foregoing types of transactions, the Adviser would need the approval of the members of the board of directors of the Fund who were not affiliated with the Adviser (or in some cases, of the Fund’s investors). The Adviser developed procedures designed to secure these approvals from the unaffiliated directors (the “PTL Procedures”).

The Complaint alleges numerous weaknesses in the PTL Procedures and their implementation, and that, beginning in 2006, the Adviser recognized that there were issues in the implementation of the PTL Procedures. The Complaint also asserts that the Adviser broker affiliate serving as the Fund’s prime broker placed a moratorium on its transactions with the Fund because of concerns over the shortcomings of the principal transaction approval process. The Complaint alleges violations of the anti-fraud provisions of the Massachusetts securities laws relating to the offering or sale of securities as a result of (a) the Adviser’s failure to obtain proper consent from the Fund’s unaffiliated directors for Related Party Transactions and (b) the continued offer and sale of interests in the two hedge funds named in the Complaint using offering materials that described procedures for Related Party Transactions that senior management of the hedge funds knew or should have known were not being followed. The Complaint also alleges that these same actions were violations of the anti-fraud provisions of the Massachusetts statutes governing the activities of investment advisers (whether or not registered in Massachusetts), as was the Adviser’s failure to comply with Section 206(3) of the Advisers Act with respect to applicable Related Party Transactions. The Complaint avers that the hedge funds had investors domiciled in Massachusetts during the relevant time period. The Complaint has numerous exhibits, including examples of letters requesting approval of Related Party Transactions and e-mail correspondence among Adviser personnel discussing Related Party Transaction approvals and related matters.

➤ **SEC Staff Provides No-Action Relief from 1940 Act Affiliated Transaction Prohibitions to Permit In-Kind Transfers in Conversion of Manager-of-Managers Funds to Affiliated Funds-of-Funds**

The staff of the SEC's Division of Investment Management (the "Staff") provided no-action relief from the affiliated transaction prohibitions of the Investment Company Act of 1940, as amended (the "1940 Act"), to allow open-end investment companies ("funds") to convert from a manager-of-managers structure to a fund-of-funds structure investing in affiliated funds (the "Target Funds") by using all the converting funds' portfolio securities and non-security assets, such as dividend and interest receivables and amounts receivable for securities sold, to make in-kind purchases of shares of the Target Funds. The funds undergoing the conversion (the "Converting Funds") are operated as asset allocation portfolios, each of which allocates its assets among various sleeves representing different investment mandates. The conversions will restructure each Converting Fund into a fund-of-funds structure in reliance on Section 12(d)(1)(G) of the 1940 Act. After the conversions, each Converting Fund will invest in affiliated funds advised by the same investment manager (the "Adviser") that have substantially similar mandates to those of sleeves used by the Converting Fund under its current manager-of-managers structure. The conversion is designed to benefit the Converting Funds by saving the proxy solicitation costs associated with selecting new subadvisers under the manager-of-managers structure and allowing the Converting Funds to more readily add investment options and increase asset diversification. By delivering all their non-cash assets for each sleeve in-kind to acquire shares of a Target Fund with a corresponding investment mandate, the Converting Funds will avoid significant transaction costs that would be incurred were they to sell those assets to realize cash for the purpose of purchasing shares of the Target Funds.

*Conditions.* The no-action relief is subject to a number of conditions that are similar to those in *Gartmore Variable Insurance Trusts* (pub. avail. Dec. 29, 2006) in which certain funds organized in a fund-of-funds structure sought to redeem in-kind their holdings in various underlying funds in the same fund complex and use those proceeds to make in-kind purchases of other affiliated funds (as discussed in greater detail in the January 16, 2007 *Alert*). The conditions in the current relief address matters such as (a) the lack of any dilution of the interests of shareholders whose funds participate in the conversions, (b) the appropriateness of the in-kind consideration being tendered to each Target Fund, (c) the transfer of all assets of each Converting Fund sleeve for the purchase of shares of a corresponding Target Fund, (d) identical portfolio valuation procedures for the Converting Funds and Target Funds and identical valuations assigned by the Converting Funds and Target Funds to the in-kind consideration and (e) the simultaneous transfer of the Converting Funds' in-kind consideration for shares of the Target Funds. The in-kind purchases effecting the conversion must follow procedures adopted by the board of each Converting Fund, including a majority of the trustees who are not "interested persons" as defined in Section 2(a)(19) of the 1940 Act ("independent trustees"), that are reasonably designed to meet the conditions discussed in the prior sentence. The boards of the Converting Funds and Target Funds must make specified findings regarding the conversion transactions within seven days following the 40 day period immediately after the transactions' completion. The Adviser must disclose to the respective independent trustees of the Converting Funds and Target Funds the existence of, and all material facts relating to, any conflicts of interest between the Adviser and the funds participating in an in-kind purchase as part of the conversions. Finally, the no-action relief requires certain recordkeeping with respect to the conversions.

➤ **SEC Votes to Codify Longstanding Policy on Shareholder Proposals Regarding Director Election Procedures and to Adopt Rules to Encourage Shareholder Forums**

At its open meeting on November 28, the SEC voted to adopt amendments to the proxy rules under the Securities Exchange Act of 1934, as amended (the "1934 Act"), that (a) codify an interpretation that shareholder proposals relating to director election procedures may properly be excluded from a company's proxy materials and (b) are designed to facilitate the use of electronic shareholder forums. The descriptions of the amendments below are based on the SEC press releases announcing them, formal release having not yet been posted on the SEC website.

Lynne B. Barr  
Gary A. Beller  
Kay E. Bondehagen  
Raymond P. Boulanger  
Agnes Bundy Scanlan  
Margaret B. Crockett  
Anna E. Dodson  
Eric R. Fischer  
Elizabeth Shea Fries  
Jackson B.R. Galloway  
James J. Kelly  
Geoffrey R.T. Kenyon  
Satish M. Kini  
William R. Kirschner  
Thomas J. LaFond  
Paul W. Lee  
Gregory J. Lyons  
Robin J. H. Maxwell  
William P. Mayer  
Philip H. Newman  
Sean P. O'Malley  
Christopher E. Palmer  
Byron C. Pavano  
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*Shareholder Proposals Regarding Director Election Procedures.* The SEC amended the proxy rules that provide various grounds for excluding a shareholder proposal from a company's proxy materials so that Rule 14a-8(i)(8) under the 1934 Act also expressly applies to a shareholder proposal that relates to a procedure for the nomination or election for membership on a company's board of directors or analogous governing body. The amendment, which was approved as proposed, responds to a 2006 decision by the U.S. Court of Appeals for the Second Circuit that was inconsistent with the interpretation reflected in the amendment. The rule amendment will take effect 30 days after it is published in the *Federal Register*.

*Electronic Shareholder Forums.* The SEC amended the proxy rules to clarify that participation in an electronic shareholder forum, which could potentially constitute a solicitation subject to the current proxy rules, will be exempt from most of the proxy rules provided certain conditions are met. Those conditions relate in part to the timing of communications by a participant in an electronic shareholder forum relative to the date announced by a company for its annual or special meeting of shareholders. In addition, the amendments provide that a shareholder company or third party acting on behalf of a shareholder or a company, that establishes, maintains or operates an electronic shareholder forum will not be liable under the federal securities laws for any statement or information provided by another person participating in the forum. The rule amendments will take effect 30 days after they are published in the *Federal Register*.

### ➤ **Second Circuit Holds National Bank Act's Prohibition against State Powers Preempts New York's Investigation into Lending Discrimination Claims**

The US Court of Appeals for the Second Circuit held that the OCC's exclusive visitorial powers promulgated under National Bank Act regulations preempt and preclude the New York Attorney General's attempts to investigate and enforce state law housing discrimination claims. The Court found the OCC's conclusion that national banks cannot be investigated and sued by the Attorney General regarding the business of banking was properly afforded *Chevron* deference, as it was not "manifestly contrary" to the National Bank Act. The Court vacated another part of the order as not ripe, ruling that the district court lacked jurisdiction to decide whether the New York Attorney General may enforce the Fair Housing Act in his *parens patriae* authority, as the Attorney General had not yet attempted to enforce the Act. *The Clearing House Association, LLC, v. Cuomo*, Docket Nos. 05-5996-cv (L), 05-6001-cv (CON) (2nd Cir. December 4, 2007).