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In this Issue:

Developments of Note

- Further Update on Federal Government Support for Money Market Funds
- Basel Committee Publishes Stress Testing Principles
- SEC Issues Release Adopting Rules Relating to Indexed Annuities
- Massachusetts Supreme Judicial Court Decides Massachusetts May Tax a Financial Institution That Has No Physical Presence in Massachusetts
- IRS Extends Prior REIT Guidance on Cash Option Stock Dividends to RICs
- OCC Issues Interpretive Letters and Files Memorandum in Federal Court Concerning Preemption of State Laws
- FDIC Requires Banks to Monitor Use of Funding from Federal Financial Stability and Guaranty Programs
- Update on Recent Developments in the Troubled Asset Relief Program

Other Item of Note

- SEC Issues Adopting Release For Mutual Fund Summary Prospectus

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Goodwin Procter Webinar: New Data Security Regulations Reach Beyond State Lines - Last Chance to Register

Goodwin Procter invites you to attend a free webinar on the new Massachusetts Data Security rules that are scheduled to go into effect on May 1, 2009. They apply to any business in possession of personal information of Massachusetts residents, whether or not that business maintains a presence in the state. This webinar will address the practical implications of these regulations for businesses nationwide. Attorneys [Lynne Barr](#), [Deborah Birnbach](#), [Agnes Bundy Scanlan](#), [David Goldstone](#) and [Jacqueline Klosek](#) from [Goodwin Procter's Privacy & Data Security Practice](#) will: examine the scope and requirements of the new rules; analyze the inter-relationship between the Massachusetts rules and other information security requirements; explore best practices for information security policy development and implementation; and share views on current trends in this area, including other states that may be considering similar legislation.

[Please click here to register for this webinar.](#)

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DEVELOPMENTS OF NOTE

Further Update on Federal Government Support for Money Market Funds

Federal Reserve Bank of New York's Money Market Investor Funding Facility

As first discussed in the October 21, 2008 *Alert*, the FRB-NY created a money market investor funding facility (the "MMIFF") to provide senior secured funding to a series of special purpose vehicles (the "SPVs") to finance until April 30, 2009 the purchase of certain instruments from registered money market funds (*i.e.*, mutual funds that comply with Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act")). The FRB-NY recently announced two changes to the MMIFF that became effective January 7, 2009.

First, the FRB-NY expanded the types of investors eligible to participate in the MMIIF to include both of the following:

- Any fund that (a) is managed or owned by a U.S. bank, insurance company, pension fund, trust company, SEC-registered investment adviser or U.S. state or local government entity; (b) maintains a dollar-weighted average portfolio maturity of 90 days or less; (c) holds fund assets until maturity under usual circumstances; and (d) holds assets that, at the time of purchase, were rated by a nationally recognized statistical rating organization in one of the three top long-term investment grade rating categories or the top two short-term investment grade rating categories, or that are the credit equivalent; and
- Any U.S. dollar-denominated cash collateral reinvestment fund, account or portfolio associated with securities lending transactions that is managed or owned by a U.S. bank, insurance company, pension fund, trust company, or SEC-registered investment adviser.

Each eligible investor must be approved by the FRB-NY before it may participate in the MMIFF. FRB-NY approval may be conditioned on debt or deposit rating criteria.

Second, the FRB-NY modified several of the economic parameters of the MMIFF, including those parameters relating to assets that may be sold to the SPVs. Among other things, each asset sold to a SPV must have a minimum size of \$250,000, be DTC cleared, have a remaining maturity of at least seven days and no more than ninety days, and have a yield of at least 60 basis points above the primary credit rate at the time of purchase by the SPV.

Goodwin Procter advised several banks that sponsor securities lending programs in connection with the modifications to the MMIFF described above.

SEC Does Not Extend Temporary Relief that Permitted Money Market Funds to Use Amortized Cost in Shadow Pricing

As discussed in the October 14, 2008 *Alert*, the Staff of the SEC's Division of Investment Management stated that it would not recommend enforcement action against any money

market fund that maintains a stable net asset value per share if the fund used the amortized cost valuation method to value certain securities when calculating the fund's market-based net asset value per share for the purposes of fulfilling the "shadow pricing" requirement of Rule 2a-7. The Staff recently determined that it would let that relief expire on January 12, 2009. Thus, after January 12, 2009, each money market fund that maintains a stable net asset value per share must calculate a shadow price based on available market quotations or an appropriate substitute for each fund asset, and not amortized cost.

Basel Committee Publishes Stress Testing Principles

The Basel Committee on Banking Supervision ("Basel Committee") published principles for sound stress testing practices and supervision (the "Principles").

Historical Problems. The Principles first describe how current events had led many banks and regulators to question whether stress testing practices (the Principles describe a "stress test" as "the evaluation of the financial position of a bank under a severe but plausible scenario to assist in decision making within the bank") were sufficient prior to the crisis. The principles then describe the 4 broad areas of perceived deficiency: (1) insufficient use of stress testing and integration in risk governance (*e.g.*, lack of diligent oversight by a bank's board and senior management, lack of stress testing covering multiple business lines, and perhaps the need for greater technology to enhance the availability and granularity of risk information); (2) insufficient stress testing methodologies (*e.g.*, methodologies that relied purely on historical data, and methodologies that did not have a comprehensive, firm-wide approach to risks); (3) insufficient scenario selection (*e.g.*, tests that did not capture extreme market events, and tests that did not consider newer products); and (4) insufficient coverage of specific risks (*e.g.*, behavior of complex products under stressed liquidity conditions, pipeline or securitization risks, and funding liquidity risk).

Recommended Improvements. After discussing the above historical shortcomings, the Principles then explain how the crisis has caused stress testing to gain greater prominence and credibility within banks. Banks are considering improvement in several areas, including: constantly reviewing scenarios and looking for new ones; evaluating risks in new products; improving identification of correlated risks and the interaction of market, credit and liquidity risk; and evaluating time horizons and feedback effects.

The Principles then make fifteen recommendations to banks, including that: (1) a bank's board and management make stress testing an integral part of corporate governance, and use it to make strategic business decisions; (2) stress testing programs should promote risk identification, improve capital and liquidity management, and enhance internal and external communication; (3) a bank should have written policies and procedures governing stress testing programs; (4) stress tests should cover a range of risks and business areas, including at the firm-wide level; (5) stress tests should be geared towards the events capable of generating the most economic or reputational damage; (6) the effectiveness of risk mitigation techniques should be systematically challenged; (7) the stress testing program should expressly cover complex products, such as securitized exposures; and (8) a bank should enhance its stress testing for highly leveraged counterparties in considering its vulnerabilities to asset categories or market movements. Finally, the Principles also make several recommendations to supervisors, including that they: make regular, comprehensive assessments of bank programs; assess and challenge the scope and severity of firm-wide scenarios; and consider stress testing (particularly forward-looking stress testing) in assessing adequacy of capital and capital under Pillar 2 of the Basel Capital Accord.

SEC Issues Release Adopting Rules Relating to Indexed Annuities

The SEC issued the release (the “Release”) regarding the adoption of new Rule 151A under the Securities Act of 1933, as amended (the “Securities Act”), which will require registration under the Securities Act of certain indexed annuities. The SEC also adopted new Rule 12h-7 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), which provides an exemption from the Exchange Act’s periodic reporting requirements for insurance companies issuing indexed annuities and certain other insurance contracts.

Rule 151A Requirements

Rule 151A under the Securities Act provides that an annuity issued by an insurance company is not an “annuity contract” or an “optional annuity contract” excluded from the Securities Act’s registration requirements under Section 3(a)(8) of the Securities Act if the annuity has both of the following two characteristics:

- (1) the contract specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of the security, including a group or index of securities; and
- (2) amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.

The first provision is intended to describe indexed annuities, the target of the rule. The SEC modified the wording of this provision to address concerns of commenters that the provision, as proposed, would have covered annuities other than indexed annuities, such as traditional fixed annuities (where amounts payable under the contract accumulate at a fixed interest rate) or discretionary excess interest contracts (where the amounts payable under the contract may include a discretionary excess interest component over and above the guaranteed minimum interest rate offered by the contract). The Release notes that while an insurance company, for example, may look to the performance of securities in its general account in establishing the rate to be provided under a traditional fixed annuity, such a contract does not obligate the insurer to do so and thus is not covered by Rule 151A. The Release also notes that annuity contracts covered by the Rule 151 safe harbor, such as certain discretionary excess interest contracts, are not required to be registered by Rule 151A.

The second provision – the “more likely than not” standard – implements the SEC’s determination that allocation of risk should be used to draw the line, on a prospective basis, between contracts that should be subject to registration under the Securities Act and those that should be entitled to exclusion under Section 3(a)(8). The SEC determined that, when the amounts payable by an insurer under an indexed annuity are more likely than not to exceed the amounts guaranteed under that annuity, the majority of the investment risk for the fluctuating, securities-linked portion of the return is born by the individual purchaser, not the insurer, and thus the purchaser is entitled to the protections provided by registration.

Rule 151A requires that the “more likely than not” determination must be made by the insurer at or prior to the issuance of the contract, provided that the following three requirements are met: (1) both the methodology and the economic, actuarial, and other assumptions used in the determination are reasonable; (2) the computations made by the

issuer in support of the determination are materially accurate; and (3) the determination is made not more than six months prior to the date on which the form of contract is first offered. The SEC did not adopt the proposed requirement that the insurer make a determination every three years.

The Release assumes that most, if not all, current indexed annuities would be required to be registered under Rule 151A. The Release cites industry data that there were 322 indexed annuities offered in 2007 by 58 different insurance companies.

Indexed Life Insurance Policies

The Release provides the following statement on indexed life insurance policies:

“The rule will not apply to contracts that are regulated under state insurance law as life insurance, health insurance, or any form of insurance other than an annuity, and it does not apply to any contract issued by an insurance company if the contract itself is not subject to regulation under state insurance law. Thus, rule 151A itself will not apply to indexed life insurance policies, in which the cash value of the policy is credited with a guaranteed minimum return and a securities-linked return. The status of an indexed life insurance policy under the federal securities laws will continue to be a facts and circumstances determination, undertaken by reference to the factors and analysis that have been articulated by the Supreme Court and the Commission. We note, however, that the considerations that form the basis for rule 151A are also relevant in analyzing indexed life insurance because indexed life insurance and indexed annuities share certain features (*e.g.*, securities-linked returns).”

Rule 151A Effective Date

The effective date of Rule 151A is January 12, 2011. The two-year delay is designed to provide sufficient time for insurers to make the determinations required by the rule and prepare registration statements for indexed annuities that are required to be registered. The delay is also designed to provide sufficient time for insurers and distributors to establish the required infrastructure for distribution of registered indexed annuities. The SEC also noted that it intends: (1) to consider how to tailor disclosure requirements for indexed annuities; and (2) to consider any requests for additional guidance that it receives regarding determinations required under Rule 151A. The Release states: “We encourage indexed annuity issuers to work with the Commission during that period to address their concerns.”

The SEC emphasized that the Rule 151A is prospective only. The Commission does not believe that issuers and sellers of indexed annuities should be subject to any additional legal risks relating to their past offers and sales of indexed annuity contracts as a result of the proposal and adoption of Rule 151A. Under the SEC’s adopted approach, the application of Rule 151A will be based on the date of the sale of a particular contract, not the date a particular form was approved by state regulators or introduced to the market. The Release provides the following clarifications:

- If an indexed annuity is issued to a particular individual purchaser on or after January 12, 2011, that specific contract is subject to Rule 151A, even if the same form of indexed annuity was offered and sold prior to January 12, 2011, and even if the individual contract issued on or after January 12, 2011, is issued under a group contract that was in place prior to January 12, 2011.

- An issuer that determines to register an annuity that is currently not registered may continue to make unregistered offers and sales of that same annuity until the earlier of (a) the effective date of the registration statement or (b) the effective date of the rule, without such offers and sales being unlawful under Section 5 of the Securities Act as a result of the pending effectiveness of Rule 151A.

Rule 12h-7 Requirements

Rule 12h-7 under the Exchange Act provides an insurance company with an exemption from Exchange Act reporting with respect to indexed annuities and certain other registered securities that are regulated as insurance under state law (including market value adjustment contracts and so-called “synthetic annuities”). The SEC concluded that it is consistent with the federal system of regulation, which has allocated the responsibility for oversight of insurers’ solvency to state insurance regulators, to exempt insurers from Exchange Act reporting with respect to state regulated insurance contracts.

In particular, Rule 12h-7 provides that an issuer is exempt from Exchange Act reporting with respect to securities registered under the Securities Act provided that each of the following six requirements is met:

- (1) The issuer is a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State;
- (2) The securities do not constitute an equity interest in the issuer and are either subject to regulation under the insurance laws of the domiciliary State of the issuer or are guarantees of securities that are subject to regulation under the insurance laws of that jurisdiction;
- (3) The issuer files an annual statement of its financial condition with, and is supervised and its financial condition examined periodically by, the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of the issuer’s domiciliary State;
- (4) The securities are not listed, traded, or quoted on an exchange, alternative trading system, inter-dealer quotation systems, electronic communications network, or any other similar system, network, or publication for trading or quoting;
- (5) The issuer takes steps reasonably designed to ensure that a trading market for the securities does not develop, including, except to the extent prohibited by the law of any State or by action of the insurance commissioner, bank commissioner, or any agency or officer performing like functions of any State, requiring written notice to, and acceptance by, the issuer prior to any assignment or other transfer of the securities and reserving the right to refuse assignments or other transfers at any time on a non-discriminatory basis; and
- (6) The prospectus for the securities contains a statement indicating that the issuer is relying on the exemption provided by this rule.

The SEC made two changes in response to comments. First, in requirement (5) above, the SEC added the provision clarifying that an insurer need not take steps designed to ensure that a trading market does not develop if those steps would be prohibited by state law. Second, the SEC added requirement (6) above to clarify that reliance on Rule 12h-7 is optional.

Rule 12h-7 Effective Date

The effective date of Rule 12h-7 is May 1, 2009.

Dissent

Commissioner Troy A. Paredes voted against the adoption of Rule 151A and provided a dissenting statement. He stated:

“I am not persuaded that Rule 151A represents merely an attempt to provide clarification to the scope of exempted securities falling within Section 3(a)(8). Instead, by defining indexed annuities in the manner done in Rule 151A, I believe the SEC will be entering into a realm that Congress prohibited us from entering. Therefore, I cannot vote in favor of the rule and respectfully dissent.”

Commissioner Paredes also outlined the reasons why he believes that Rule 151A conflicts with the two U.S. Supreme Court cases construing the scope of Section 3(a)(8). He questioned the “more likely than not” test, which in his view would result in the registration of all indexed annuities.

Massachusetts Supreme Judicial Court Decides Massachusetts May Tax a Financial Institution That Has No Physical Presence in Massachusetts

In *Capital One Bank. v. Commissioner of Revenue*, Dkt. No. SJC-10105 (Jan. 8, 2009), the Massachusetts Supreme Judicial Court (the “SJC”) decided that Massachusetts may impose its financial institution excise on an out-of-state financial institution that does not have a physical presence in Massachusetts if the financial institution has “substantial nexus” with the Commonwealth. The bank’s principal claim was that imposition of the excise violated the Commerce Clause of the U.S. Constitution. Under well-established U.S. Supreme Court case law, one of the requirements for a state tax to comply with the Commerce Clause is that the taxpayer have “substantial nexus” with the taxing state. The Court, in *Quill Corp. v. North Dakota*, 504 U.S. 298, 317-318 (1992), reaffirmed an earlier decision that, with respect to the imposition of sales and use taxes, the constitutionally sustainable measure of contact required for substantial nexus under the Commerce Clause was “physical presence” in the taxing State. Here, the bank argued that the physical presence requirement is not limited to the sales and use tax context but is also required before the state can impose an income-based tax, like the Massachusetts financial institution excise, on an out-of-state entity.

The SJC disagreed. It determined that

The language of the Supreme Court’s decision in *Quill* explicitly emphasized, on more than one occasion, a narrow focus on sales and use taxes for the physical presence requirement, and suggested that this requirement was limited to those specific assessments and did not apply to the imposition of other types of State taxes. We will not expand the Court’s reasoning beyond its articulated boundaries, particularly where the Court, itself, has limited its holding to a particular form of taxation.

The SJC then turned to the facts before it in *Capital One Bank* to determine whether the bank had substantial nexus with Massachusetts during the tax years at issue. It noted that “[w]hile the concept of ‘substantial nexus’ is more elastic than ‘physical presence,’ it

plainly means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry. Simply put, the test is ‘substantial’ nexus, not ‘minimal’ nexus [internal reference omitted].”

In this case, based upon the Appellate Tax Board’s findings of fact, the SJC determined that the bank did have substantial nexus with Massachusetts because of its deliberate and targeted exploitation of the Massachusetts economic market and use of the Commonwealth’s governmental infrastructure and resources.

IRS Extends Prior REIT Guidance on Cash Option Stock Dividends to RICs

The Internal Revenue Service (the “IRS”) recently issued Revenue Procedure 2009-15 (the “Revenue Procedure”), which indicates that a cash option stock dividend will satisfy the distribution requirements for a publicly traded RIC or REIT (each, a “Company”) for 2008 and 2009 so long as shareholders can elect to take at least 10% of the dividend in cash. (A RIC or REIT is “publicly traded” if its stock is publicly traded on an established securities market in the United States.) The Revenue Procedure supersedes substantially identical guidance previously provided solely to REITs in Revenue Procedure 2008-68.

The Revenue Procedure provides that the IRS will treat a capped cash option stock dividend paid by a Company as a taxable dividend, and will consider the amount of stock distributed to be equal to the amount of cash which stockholders could have received instead, if:

- (1) the dividend is made by the Company to its shareholders with respect to its stock;
- (2) the terms of the dividend allow each shareholder the right to elect to receive its entire distribution in either cash or stock of the Company of equivalent value, provided that the Company may impose a limitation on the amount of cash to be distributed in the aggregate to all shareholders of not less than 10% of the aggregate distribution; and
- (3) the number of shares to be distributed is determined as close as practicable to the payment date based upon a formula utilizing market prices, designed to equate in value the number of shares to be received with the amount of money that could be received instead.

The Revenue Procedure further provides that, to the extent a shareholder participates in a Company’s dividend reinvestment plan (a “DRIP”), only the cash portion of a dividend paid in accordance with the Revenue Procedure is subject to the DRIP. The guidance in the Revenue Procedure applies only to distributions with respect to taxable years ending on or before December 31, 2009.

OCC Issues Interpretive Letters and Files Memorandum in Federal Court Concerning Preemption of State Laws

Interpretive Letters. In interpretive letter #1103 (“Letter 1103”) and interpretive letter #1106 (“Letter 1106”) and together with Letter 1103, the “Letters”), the OCC concluded that 12 U.S.C. § 92a (“Section 92a”) and Part 9 of the OCC’s regulations preempt state laws that impose preconditions on national banks exercising fiduciary powers. Section 92a authorizes the OCC to permit national banks to act as, among other things, trustees, executors, administrators, registrars of stocks and bonds, guardians of estates “or in any other fiduciary capacity” allowed for state banks, trust companies or other corporations that

compete with national banks under the law of the state where the national bank is located. Prior to the issuance of the Letters, several states sought to limit the activities of certain unnamed national banks that offer fiduciary services.

In Letter 1103, a national bank sought to provide fiduciary services in North Carolina through its offices in other states, as authorized by OCC regulations. North Carolina law, however, requires that institutions providing trust services within the state obtain a license and maintain a trust office in the state. In concluding that Section 92a preempts North Carolina's requirements, Letter 1103 reasoned that Section 92a imposes no limitations on where a national bank may market its fiduciary services. Because the OCC's regulations expressly provide that a national bank may act as a fiduciary in any state, the OCC's regulations preempt the preconditions imposed by North Carolina authorities.

As described in Letter 1106, Georgia and South Carolina sought to limit the fiduciary services offered by a national bank for customers and property located in Georgia and South Carolina, notwithstanding that the national bank was not located in either state. In addition, Florida sought to require a national bank to provide pledges or deposits in excess of requirements under applicable OCC regulations. In Letter 1106, the OCC concluded that Section 92a and Part 9 of the OCC's regulations permit a national bank to act as a fiduciary in Georgia and South Carolina notwithstanding state laws restricting its ability to do so. Letter 1106 also states that a national bank need not comply with Florida deposit requirements mandating deposit levels in excess of federal law.

Preemption Memorandum. The OCC also filed a memorandum *amicus curiae* in a lawsuit pending in the U.S. District Court for the Northern District of Ohio (*Cleveland v. Deutsche Bank Trust Co.*, N.D. Ohio, No. 1:08-cv-00139), requesting that the court dismiss the state cause of action. The action, commenced by the City of Cleveland, claims that lenders, investment banks and related companies are subject to liability under state law for their role in subprime lending and "securitization." In its memorandum *amicus curiae*, the OCC claims that the Supremacy Clause of the United States Constitution preempts state law claims against the national bank. The case is currently pending.

FDIC Requires Banks to Monitor Use of Funding from Federal Financial Stability and Guaranty Programs

The FDIC issued Financial Institution Letter 01-2009, which states that state nonmember banks should implement a process to monitor their use of capital injections, liquidity support and financing guarantees obtained through the recent financial stability programs established by the Treasury, the FDIC and the FRB. The monitoring processes should help to determine how participation in these federal programs has assisted such institutions in supporting prudent lending or supporting efforts to work with existing borrowers to avoid unnecessary foreclosures. The FDIC encouraged institutions to include a summary of this information in shareholder and public reports, annual reports and financial statements. State nonmember banks should also describe their utilization of federal funding during bank examinations.

Update on Recent Developments in the Troubled Asset Relief Program

President Bush formally requested that Congress release the second \$350 billion in funding for the Treasury's Troubled Asset Relief Program (TARP). Also, Treasury Interim Assistant Secretary for Financial Stability Neel Kashkari announced that the Treasury will

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post its term sheet for S-corporations to participate in the TARP Capital Purchase Program on January 14, 2009. The application period will open on January 14 and will remain open for 30 days. The Treasury has not yet issued a term sheet that would allow mutual financial institutions to participate in the TARP Capital Purchase Program.

OTHER ITEM OF NOTE

SEC Issues Adopting Release For Mutual Fund Summary Prospectus

The SEC has issued the formal release describing the disclosure reforms for registered open-end management investment companies (“mutual funds”) adopted at its open meeting on Wednesday, November 19, 2008. These reforms (i) revise the disclosure requirements for the statutory prospectus currently used by mutual funds and (ii) create the new Summary Prospectus for use in mutual fund sales. The release also describes amendments to SEC rules designed to provide more useful disclosure to investors who purchase shares of exchange-traded funds in the secondary market. The revised disclosure requirements create a brief, self-contained presentation of key fund characteristics that must appear in the current statutory prospectus and will constitute the new Summary Prospectus. Funds will be able to use the Summary Prospectus to satisfy certain prospectus use and delivery requirements under the Securities Act of 1933, as amended (the “1933 Act”), subject to several conditions that include providing investors access to the statutory prospectus and other fund documents via the Internet.

Effective/Compliance Dates. The effective date of the new requirements is March 31, 2009. A mutual fund may choose to prepare documents in accordance with the new disclosure requirements at any time after this effective date. If a mutual fund has complied with the new requirements, a Summary Prospectus for the fund may be used to satisfy prospectus use and delivery obligations provided related conditions in the reforms are satisfied. The schedule for mandatory implementation of the reforms follows the usual practice for this type of disclosure initiative by providing an opportunity for the SEC staff to review and comment on the manner in which each fund complies with the new requirements. All initial registration statements on Form N-1A, which dictates the contents of the mutual fund statutory prospectus, and all post-effective amendments that are annual updates to effective registration statements on Form N-1A, filed on or after January 1, 2010, must comply with the new disclosure requirements. All post-effective amendments that add a new series, filed on or after January 1, 2010, must comply with the new disclosure requirements with respect to the new series. The final date for filing post-effective amendments that comply with the new requirements is January 1, 2011. Post-effective amendments to existing registration statements filed to comply with the new disclosure requirements must be filed under 1933 Act Rule 485(a), which permits an effective date on the sixtieth day (the seventy-fifth day for a new series) after filing at the earliest (subject to acceleration at the SEC staff's discretion), prior to which time the SEC staff typically reviews and comments on the filing. The *Alert* will provide a more detailed description of the adopting release in an upcoming issue.

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