

Financial Services Alert

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Developments of Note

➤ SEC Issues Release Proposing a Modified Accredited Investor Standard for Natural Persons Investing in Certain 3(c)(1) Funds and a New Advisers Act Anti-Fraud Rule

The SEC issued the formal release (the "Release") proposing a modified accredited investor standard under the Securities Act of 1933, as amended (the "1933 Act"), for investments by natural persons in certain funds ("3(c)(1) funds") relying on Section 3(c)(1) of the Investment Company Act of 1940, as amended (the "1940 Act"), and a new anti-fraud rule under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). In summary, the proposals provide for:

- new rules relating to offerings relying on the exemptions from registration under the 1933 Act provided for in Regulation D and Section 4(6) under the 1933 Act, that establish an additional standard that each natural person seeking to invest in most 3(c)(1) funds must meet in order to do so as an accredited investor; the new "accredited natural person" standard would require a natural person investor to meet (a) one or the other of the existing net worth and income tests for natural person accredited investors and (b) a new criterion (modeled after the requirements for natural person investors in funds relying on Section 3(c)(7) under the 1940 Act ("3(c)(7) funds")) under which the investor must own \$2.5 million in qualifying "investments."
- a new anti-fraud rule under Section 206(4) of the Advisers Act targeting the actions of investment advisers (registered and unregistered) with respect to investors and potential investors in registered investment companies and in 3(c)(1) funds and 3(c)(7) funds (collectively "pooled investment vehicles"); the new rule is designed to address any uncertainty created by the Goldstein decision regarding the SEC's ability to bring enforcement actions under the Advisers Act against an investment adviser believed to have defrauded investors or prospective investors in a hedge fund or other pooled investment vehicle the adviser manages.

Comments on the proposed rules must be received by the SEC on or before March 9, 2007. A more detailed discussion of the proposed rules will be made available via a future *Alert*.

➤ SEC Publishes Staff Economic Papers on Fund Governance Issues in Connection with Reopening Comment Period on Challenged Fund Governance Requirements

In connection with reopening the comment period on certain registered investment company ("fund") governance requirements (as discussed in the December 19, 2006 *Alert*), the SEC published two economic papers (the "Papers") prepared by its Office of Economic Analysis that (i) review existing

economic literature related to advisers' conflicts of interest with respect to funds they advise, as well as literature related to mutual fund governance, independent chairmen and board independence; and (2) analyze the statistical properties of mutual fund returns and potential limitations inherent in any empirical analysis designed to identify a relationship between those returns and fund governance. By reopening the comment period, the SEC indicated that it hoped to develop a more comprehensive record and a more thorough understanding of the economic consequences of the fund governance requirements in question and therefore was inviting comment on the Papers, in addition to seeking comment on any other extant analyses and commenters' best assessment of them. In conjunction with publishing the Papers, the SEC announced that comments must be received on or before March 2, 2007.

➤ **Director of SEC's Division of Investment Management Discusses Exemptive Applications Process Improvements at ICI Procedures Conference**

At the December 2006 ICI Procedures Conference, Andrew J. Donohue, Director of the SEC's Division of Investment Management (the "Division"), discussed efforts being made by the Division to improve the processing of exemptive applications. He also discussed initiatives designed to indirectly improve exemptive application processing by codifying certain types of frequently granted exemptive relief as exemptive rules. The measures discussed by Mr. Donohue correspond to recommendations made by the SEC Office of Inspector General in a report issued earlier this year detailing findings of an audit of the Division's exemptive application process. (The Inspector General's report was summarized in the October 17, 2006 *Alert*.)

Improvements to the Exemptive Application Process. Mr. Donohue outlined some of the steps that the Division staff is taking to improve efficiency in the Division's processing of exemptive applications. These include efforts to improve communications with applicants during the process, such as the following:

- *Notice of Receipt* – Shortly after filing a new application, an applicant should receive a call confirming receipt of the application, identifying the staff attorney assigned to the application and providing a telephone number that case be used to check on the application's status.
- *Status Updates* – An applicant will receive a "status update" call within 60 days after filing. In addition, if there has been no communication between an applicant and the Division staff for any 60-day period, the applicant should receive an additional call providing an update. During intervening periods, an applicant may call the Division staff to request a status update. Mr. Donohue indicated that the Division staff is committed to returning all calls from applicants in a prompt manner, which generally means by the end of the next business day.

Mr. Donohue indicated the staff has set an aggressive goal of essentially doubling the number of exemptive orders that are issued this fiscal year. As a result, many applicants can expect to receive initial comments on their applications more quickly. The Division is also pursuing an initiative that would provide for electronic filing of exemptive applications on EDGAR.

Helpful Hints to Applicants. Mr. Donohue provided a number of recommendations from Division staff to help applicants with the exemptive relief process, including the following:

Before filing an application, applicants should -

- call the Division's Applications Office for guidance on the most recent developments and the best precedent to use. Mr. Donohue generally encouraged potential applicants to communicate in advance of filing with the staff in order to facilitate consideration of the exemptive relief being sought.
- anticipate the staff's questions and concerns when drafting the application. For example, if an application deviates from relevant precedent, explain the differences and the reasons for the differences in detail in the cover letter for the application.

- ensure that they are not submitting a hastily drafted application just to “get in line.” Mr. Donohue observed that a quickly drafted application takes longer to review than a well drafted one that might be farther back in the line. Mr. Donohue also indicated that he had encouraged the Applications Office to reject poorly drafted applications.
- have the application’s preparation supervised by an experienced 1940 Act attorney.

When filing an application, applicants should -

- make sure the application is properly filed because misfiling can result in weeks of delays. Mr. Donohue indicated that the Division’s Applications Office is available to answer questions about the filing process.
- to the extent a new application closely tracks a prior application, provide the staff with a copy of the new application marked to show changes from the prior application.

Mr. Donohue urged applicants to work with the Division staff in responding to comments the staff provides on applications and contact the staff when they do not understand comments they have received. He also encouraged applicants to tell the staff about deadlines ahead of time, noting that the staff does its best to accommodate applicants’ deadlines, but needs reasonable notice to do so.

Codification. Mr. Donohue discussed past efforts, and efforts currently underway, to codify the terms of certain types of frequently-granted exemptive relief as exemptive rules. He noted that the SEC had adopted new fund-of-funds rules, which codified previously granted exemptive orders and eliminated the need to file an exemptive application when structuring many fund-of-funds arrangements. Mr. Donohue indicated that the staff is preparing a recommendation for adoption of a manager-of-managers rule (which was proposed in October 2003, as discussed in the October 28, 2003 *Alert*) and a recommendation for proposal of an index-based exchange traded fund rule. The Division is also in the process of addressing the backlog of applications relating to managed distribution plans by imposing a new and unified set of conditions for applicants requesting this type of relief and considering a new exemptive rule in this area.

➤ SEC OCIE Director Discusses Examinations of Fund and Adviser CCO Annual Reviews

In a speech given at the December 2006 ICI Procedures Conference, Lori A. Richards, Director of the SEC’s Office of Compliance Inspections and Examinations (“OCIE”), discussed the results of OCIE’s examination of annual reviews conducted by registered investment companies (“funds”) and registered advisers pursuant to Rule 38a-1 under the Investment Company Act of 1940, as amended (the “1940 Act”), and Rule 206(4)-7 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), respectively. She discussed (a) the factors considered by OCIE in evaluating annual reviews, (b) the scope of reviews conducted by the funds and advisers examined, (c) how funds and advisers handled the requirement to report material compliance matters to fund boards under Rule 38a-1, (d) who conducted annual reviews, (e) how reviews were conducted, (f) recommendations resulting from annual reviews and (g) deficiencies identified by OCIE in fund and adviser annual reviews.

Ms. Richards indicated that OCIE examiners found indications that 60% of the firms visited conducted a “solid annual review.” She noted that at many firms the annual review was comprehensive, encompassing all compliance policies and procedures, included forensic tests, identified compliance risk areas where there was weakness and reviewed the firm’s risk inventory for completeness. She noted that many annual reviews also included a focus on changes in the firm’s business, product lines, personnel and applicable regulations. For the remaining 40% of funds and advisers examined, OCIE examiners found either that there was no evidence that an annual review had taken place, or the annual review provided little or no assurance that the firm’s compliance program would be effective.

Factors Considered by OCIE. Ms. Richards listed the following factors considered by OCIE examiners in evaluating firms’ annual reviews:

- Who conducted the annual review?
- What was the scope of the review, and how was the scope determined (*i.e.*, was a risk-assessment completed, did the scope include existing compliance policies and procedures, did it review the firm's process for identifying gaps)?
- When was it performed?
- How was it performed? (*e.g.*, using a checklist, forensic tests, review of past exceptions.)
- What were the review's findings? (OCIE staff would expect that thorough reviews would be likely to have findings and/or areas where the firm's compliance programs could be proactively improved.)
- What recommendations were made by the staff who conducted the review? (Do they appear to adequately address the findings?)
- What is the current status of those recommendations - have they been implemented?
- What documentation was created and retained by the firm to reflect the work done?
- What, if any, was the involvement of senior management in the review?

Scope of Annual Reviews. Ms. Richards indicated that for annual reviews that appeared to meet applicable requirements, the scope of review included the following:

- Code of Ethics and Personal Trading
- Portfolio Management, Research and Proxy Voting
- Business Continuity/Disaster Recovery
- Capturing/Compiling/Preserving/Protecting Information
- Brokerage Arrangements and Best Execution
- Safekeeping of Client Assets
- Anti-Money Laundering
- Marketing, Advertising, Calculating Performance
- Distribution of Fund Shares
- Trade Allocations
- Reporting/Disclosures/Form ADV
- Pricing and Client Position Valuation
- Fund Corporate Governance
- Back Office Functions and Advisory Fee Billing
- Service Providers' Compliance Programs
- Specific Compliance Risks (*e.g.*, those applicable to variable product funds and money market funds)
- E-mail and Books and Records Retention
- Market Timing and Late Trading
- Restricted or Illiquid Securities
- Segregation of Collateral

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Melanie L. Fein
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- Solicitation Arrangements
- Sub-Adviser Oversight

Material Compliance Issues. Ms. Richards discussed how funds and advisers examined by OCIE addressed the requirement under Rule 38a-1 that the annual report to a fund's board by the fund's Chief Compliance Officer ("CCO") address each material compliance matter that occurred since the date of the last report. (Rule 38a-1 defines material compliance matter to mean any compliance matter about which a fund's board of directors would reasonably need to know to oversee fund compliance, and that involves, without limitation: (i) a violation of the federal securities laws by the fund, its investment adviser, principal underwriter, administrator or transfer agent (or officers, directors, employees or agents thereof); (ii) a violation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent; or (iii) a weakness in the design or implementation of the policies and procedures of the fund, its investment adviser, principal underwriter, administrator or transfer agent.) She observed that perhaps more work could be done by CCOs of both advisers and funds to work with senior management or fund boards (as the case may be) to identify and better define expectations about the types of matters that should be reported. She went on to note that only a few firms examined had fleshed out the Rule 38a-1 definition and those that did most often said that it included "a reasonable need to know by management" and/or took into account "harm to investors" and the "repetitive nature of the issue." She added that even funds that did not report material compliance matters nevertheless reported to their boards on other less serious compliance matters found in the annual review.

Who Conducted the Annual Review. OCIE found that the CCO generally did all or substantially all of the work involved in the annual review, with about a quarter of the firms also involving business personnel. Over half of the firms indicated that senior management was involved or provided oversight in some way. Some firms used outside counsel and/or a compliance consultant for some facet of the annual review. None of the firms examined appeared to use their internal audit staff although Ms. Richards saw this as a viable option.

How Annual Reviews Were Conducted. Ms. Richards indicated that most firms used a combination of the following approaches to conduct the review, generally completing the review over a one to three month period, although almost a quarter of firms examined conducted the review over a longer, rolling period:

- reviewing policies and procedures
- comparing them to current practices
- conducting interviews with business personnel
- identifying risks and mapping them to current policies and procedures
- conducting forensic testing

Only a small number of firms reviewed exceptions that had been identified in the last year for patterns and weaknesses.

Recommendations Based on Annual Reviews. OCIE found that the most common recommendation arising out of annual reviews was to improve, change or strengthen the firm's policies and procedures. Other more specific recommendations included committing additional resources to compliance, improving disclosures, improving documentation, improving oversight of service providers, implementing or improving forensic testing, and improving the risk assessment process. Most firms appeared to have implemented recommendations from their annual reviews or were in the process of doing so.