

# Financial Services Alert

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## *Developments of Note*

### **➤ SEC Votes to Propose New Mutual Fund Summary Disclosure Document and Related Changes to Mutual Fund Prospectus Disclosure Requirements**

At its open meeting on November 15, 2007, the SEC voted to propose (a) a new summary disclosure document for use in mutual fund sales and (b) related changes to mutual fund prospectus disclosure requirements. This article summarizes the proposal as described in an SEC staff presentation at the open meeting and in the SEC’s subsequent press release announcing the Commissioners’ unanimous vote to issue the proposal. A more definitive description with additional details will be available in a formal proposing release, which will be discussed in the *Alert* once the release is published.

The SEC’s proposal centers on new summary disclosure requirements for mutual funds that would address what the Commission regards as key fund characteristics. These disclosure requirements, which are similar to those for the Profile Plus disclosure document recommended by the NASD Mutual Fund Task Force in 2005 (see the March 29, 2005 Alert), would apply to the statutory prospectus currently prescribed for mutual funds. The proposed disclosure requirements would also apply to a new stand alone mutual fund summary disclosure document that could be used to satisfy the prospectus delivery requirements of the Securities Act of 1933, as amended (the “1933 Act”), provided certain conditions regarding access to the statutory prospectus and other fund information (such as a fund’s statement of additional information and most recent shareholder reports) on-line and in paper format were met. The summary disclosure document could be provided in paper or electronic form although an investor would have to affirmatively consent to the latter.

*Summary Disclosure Requirements.* The proposed summary disclosure requirements would mandate a plain English presentation of information on specified topics in a prescribed order. The proposed disclosure would appear at the front of statutory prospectuses. The specified topics would be a fund’s investment objective, costs, principal investment strategies, principal risks, performance, top ten holdings, portfolio management, purchase and sale procedures, tax consequences and financial intermediary compensation. The proposal would not permit multi-fund presentations of summary

disclosure information. In other words, for funds offered together in a multi-fund prospectus, each fund would have to have its own separate presentation of the proposed summary disclosure information. Similarly, each fund's stand alone summary disclosure document could include information only with respect to that fund, and only information that is responsive to the proposed requirements. However, in each case, a fund's summary disclosure information could reflect multiple classes of the fund, although other information could accompany the summary disclosure document.

*Summary Disclosure Documents – Quarterly Performance Updates.* A fund would be required to update performance information in its stand alone summary disclosure document each calendar quarter (but generally update the summary disclosure document in its entirety only on an annual basis). The quarterly performance update requirement would not apply to the corresponding summary disclosure information in a fund's statutory prospectus or registration statement. In addition, there would be no requirement to send an updated summary disclosure document to an investor simply because the investor had received a summary disclosure document whose performance information was now less current.

*Summary Disclosure Documents – On-Line Access.* On-line access to a fund's statutory prospectus and other information in conjunction with the use of the proposed summary disclosure document would need to meet a number of conditions: (a) access would need to be free of charge; (b) access would need to be available on or before a summary disclosure document was sent or given to an investor and would need to be maintained until 90 days after use of the summary disclosure document; (c) an investor would need to be able to read and print the documents available on the internet; (d) an investor would need to be able to readily move back and forth directly between information in the summary disclosure document and more detailed disclosure in related sections of the statutory prospectus and statement of additional information; and (e) an investor would need to be able to permanently retain a copy of the electronic statutory prospectus.

*Securities Law Liability Issues.* The SEC staff presentation at the open meeting devoted considerable attention to elements of the proposal that would address various potential liability issues under the federal securities laws associated with the use of the summary disclosure document in mutual fund sales efforts.

- *Prospectus Delivery Requirements.* Under proposed amendments to Rule 498 under the 1933 Act, delivery of the summary disclosure document would satisfy the prospectus delivery requirements of Section 5(b)(2) of the 1933 Act if the conditions noted above regarding the availability of the statutory prospectus and other fund information on-line and in paper form upon request were met. Failure to send a paper copy of the statutory prospectus in response to an investor request would not result in the violation of Section 5(b)(2) but would be a violation of amended Rule 498. An investor's receipt of a summary disclosure document would also allow delivery of other types of communications that offer fund shares for sale but do not meet 1933 Act prospectus requirements, e.g., fund sales literature. Proposed amendments to Rule 498 would also provide a safe harbor for a fund using a summary disclosure document when it was temporarily unable to comply with the on-line access requirements of the Rule because of technical issues if the fund had reasonable procedures to correct a problem with on-line statutory prospectus availability as soon as practicable after the fund knows, or should have known, of the problem.
- *Incorporation by Reference.* A fund could incorporate by reference the fund's statutory prospectus, statement of additional information and shareholder reports into a summary disclosure document. The proposal would treat information properly incorporated by reference into the summary disclosure document as having been conveyed to the purchaser of fund shares at the time of sale for purposes of Rule 159 under the 1933 Act, which defines the scope of information treated as having been provided to a purchaser when determining whether or not there has been a material misstatement or omission resulting in liability under the anti-fraud provisions of Section 12(a)(2) and Section 17(a)(2) of the 1933 Act.

- *Status vis-à-vis Registration Statement.* The summary disclosure document would be filed with the SEC as part of the registration statement but would not be deemed part of the registration statement for purposes of Section 11 of the 1933 Act, which addresses liability for a false registration statement.

*Point of Sale Disclosure.* Commissioner Nazareth noted that the proposed summary disclosure information included financial intermediary compensation, an element of a 2004 SEC proposal regarding broker-dealer point of sale disclosure. In response to a question from Ms. Nazareth, a representative of the Division of Trading & Markets (formerly the Division of Market Regulation) indicated that in early 2008 the Division intended to make a recommendation to the Commission with respect to reproposing point of sale disclosure requirements.

*Public Comment.* The SEC staff and the Commissioners indicated that they were eager to receive public comment on the proposal, which could be submitted through the 90<sup>th</sup> day following the proposal's publication in the *Federal Register*.

### ➤ SEC Issues Concept Release on Disclosures Relating to Business Activities in Countries Designated as State Sponsors of Terrorism

The SEC issued a concept release on whether to develop a mechanism for enhancing access to disclosures concerning public companies' business activities in or with countries designated as sponsors of terrorism. The SEC is soliciting public comment on the concept release; comments will be accepted for 60 days after the release is published in the *Federal Register*.

The U.S. State Department publishes a list of countries that it has designated as sponsors of terrorism ("Listed Countries"). There currently are five countries on the State Department list: Cuba, Iran, North Korea, Sudan, and Syria. The SEC's Office of Global Security Risk monitors public company disclosure of material business activities in or with Listed Countries and, earlier this year, the SEC added a feature to its website that provided direct public access to disclosures made by public companies in their 2006 annual reports concerning past, current, or anticipated business activities in or with Listed Countries. The SEC web tool also gave interested persons a way to link directly to the full text of a company's annual report, where interested parties could read the company's disclosures regarding its activities in Listed Countries.

The SEC's web tool drew many visits and comments. Many public companies expressed concern that the web tool did not disclose the most recent information about a company's activities, could be misleading (regardless of the legality and appropriateness of a company's activities), and could lead to significant reputational harm. As a consequence, the SEC suspended the web tool on July 20, approximately one month after its initiation.

At this juncture, the SEC is seeking the public's views on whether to re-initiate a mechanism for easy access to public company filings regarding business with or in Listed Countries and, if so, what form such enhanced access should take. The SEC notes that the information provided by public companies regarding business activities in or with Listed Countries is currently available through the EDGAR database, and the SEC asks whether providing easier access to companies' public disclosures is appropriate or necessary. The SEC also asks what means, if any, should be used to provide easier access to public companies' disclosures. One option is enhancing the SEC web tool, for example, by broadening the universe of available disclosure documents – to address perceived deficiencies in the version of that tool used earlier this year. A second option is to allow companies to use "data tagging" in SEC filings to identify disclosure regarding their business activities in or with Listed Countries, which would allow companies to determine which disclosures would be called up in response to web-based searches for this information.

### ➤ MFA Releases “Sound Practices for Hedge Fund Managers”

The Managed Funds Association (the “MFA”), a trade organization for the global alternative investment industry (hedge funds, funds of funds and managed futures funds), has released an updated version of its publication, *Sound Practices for Hedge Fund Managers*, in response to the President’s Working Group on Financial Markets’ call for the hedge fund industry to establish standards of excellence for improved market discipline and enhanced vigilance through collaborative efforts among counterparties. *Sound Practices*, which was originally published in 2000 and is now in its fourth edition, contains recommendations that provide hedge fund managers with a framework of internal policies, practices, and controls. (A number of other investment management industry trade groups have published best practices guidelines that address hedge fund management, including the CFA Institute’s Standards of Practice Handbook (June 2005), and the Investment Company Institute’s Side-by-Side Management of Registered Investment Companies and Investment Accounts (March 2004).)

The latest edition of *Sound Practices*, published in November 2007, includes substantive updates on valuation, risk management and responsibilities to investors. It introduces a model due diligence questionnaire designed to identify the kinds of questions that a potential investor may wish to consider before investing in a hedge fund, and includes guidance on developing anti-money laundering programs, a list of regulatory filings that a hedge fund manager may be required to file in the United States, and checklists for creating a compliance manual and a code of ethics. The recommendations included in *Sound Practices* are generally directed toward hedge fund managers with business operations and investments in the United States. However, MFA views the recommendations as useful tools for hedge fund managers around the world.

*Sound Practices* addresses seven main topics:

- **Management, internal trading, and information technology controls.** Guidance on the oversight and monitoring of portfolio managers and trading activities; information technology controls and maintenance of data security; and oversight of relationships with third-party service providers.
- **Responsibilities to investors.** Recommendations and guidance on developing policies and procedures to address potential or actual material conflicts of interest and ensure that investors are provided with adequate information to enable investors to understand and evaluate their investments.
- **Determination of net asset value.** Guidance on establishing policies and procedures for the determination of NAV that are fair, consistent, and verifiable.
- **Risk measurement.** Guidance on key aspects of a robust process for dealing with the measurement, monitoring, and management of risks, including market risks, funding liquidity risks, counterparty credit risks and operational risks.
- **Key regulatory controls and compliance issues.** Recommendations on monitoring and managing regulatory responsibilities, developing compliance policies and procedures, training of personnel and monitoring of developments in applicable laws, rules, and regulations.
- **Trading relationships, monitoring, and disclosure.** Guidance on managing trading relationships with third parties, monitoring and documenting transactions, seeking to obtain best execution and establishing procedures for using and disclosing soft dollar arrangements.
- **Business continuity, disaster recovery, and crisis management planning.** Guidance on developing policies and procedures to prepare for unexpected events that may interfere with operations, cause harm to personnel or infrastructure, or hamper or prohibit the continuation of business operations.

*Sound Practices* also includes the following appendices, which are designed to assist hedge fund managers in implementing the recommendations in *Sound Practices*:

- a glossary of industry and relevant terms;
- a model due diligence questionnaire for hedge fund investors, which contains commonly asked questions a hedge fund manager should be prepared to receive from current or prospective investors;
- supplemental risk monitoring information and practices, including a description of specific risk management techniques and methodologies that should be considered as part of sound risk monitoring practices;
- guidance on developing anti-money laundering programs;
- a list of U.S. regulatory filings that may be applicable to a hedge fund manager; and
- checklists for hedge fund managers to consider in developing a compliance manual and a code of ethics.

The MFA notes that the recommendations included in *Sound Practices* are not one-size-fits-all prescriptive requirements applicable to all hedge fund managers in the same manner. Rather, they should be tailored and applied to individual organizations based on the size, nature, and complexity of their operations, their strategies and resources, as well as the objectives of the hedge funds they manage. The MFA also notes that *Sound Practices* is not intended to serve as legal or professional advice, but rather intended to provide a general description and recommendation of management and business practices to consider.

### ➤ **FINRA Sets Effective Date for New Rule Governing Deferred Variable Annuity Sales and Exchanges**

The Financial Industry Regulatory Authority (“FINRA,” formerly the NASD) has set May 5, 2008 as the effective date for new NASD Rule 2821, which establishes new suitability, supervisory and training requirements for sales and exchanges of deferred variable annuities. The rule’s requirements were summarized in the September 18, 2007 *Alert*. FINRA announced the rule and the effective date in Regulatory Notice 07-53 (November 2007), which is available on FINRA’s website.

Regulatory Notice 07-53 also sets forth important interpretive guidance regarding new Rule 2821 and its implementation.

- *Effect of Prospectus Delivery.* Mere delivery of a prospectus to an investor ordinarily would not be enough to meet the rule’s requirement that a registered representative have a reasonable basis to believe that the customer has been informed, in general terms, of the material features of a variable annuity.
- *Applicability to Exchanges.* The rule’s requirements for exchanges apply to exchanges from one variable annuity to another variable annuity, not to exchanges between a fixed annuity and a variable annuity. (The purchase requirements would apply to a fixed annuity to variable annuity exchange.)
- *Due Diligence Regarding Past Exchanges.* A registered representative must determine whether the customer has effected another exchange at the broker-dealer at which he or she is performing the review and must make reasonable efforts to ascertain whether the customer has effected an exchange at any other broker-dealer within the preceding 36 months. FINRA generally would view asking customers whether they had an exchange at another broker-dealer within 36 months to be a reasonable effort in this context.
- *Principal Review.* The rule requires that principal review be completed before transmittal of the application to the insurance company. (The Regulatory Notice also provides guidance on the application of that requirement to a broker-dealer affiliated with the issuing life insurance company.) The application is deemed transmitted to the insurance company only when the broker-dealer’s principal has approved the transaction, provided that the broker-dealer ensures that

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arrangements and safeguards exist to prevent the insurance company from issuing the contract prior to principal approval. The rule does not permit customer funds to be deposited in an account at the insurance company prior to completion of principal review. In addition, the rule provides that the seven business day principal review and approval deadline starts when the customer signs the application.

A FINRA representative stated at an industry conference that FINRA does not expect to issue any other formal guidance on the rule prior to its effective date.

### ➤ **ICI and IDC Issue Overview of Fund Governance Practices 1994-2006**

The Investment Company Institute and the Independent Directors Council issued an updated overview of fund governance practices that looks at common fund governance practices during the period 1994-2006, based on data collected from participating fund complexes. The overview provides statistics in the following areas, along with brief explanatory discussions:

- Fund Total Net Assets and Total Independent Directors, by Year
- Net Assets Served by Independent Directors
- Funds Served by Independent Directors
- Board Structure - Unitary or Cluster Boards
- Complexes with 75 Percent Independent Directors
- Number of Independent Directors for each Complex
- Frequency of Board Meetings
- Board Meetings and Committee Meetings in which Independent Directors Participated
- Independent Board Chair or Lead Director
- Director Fund Share Ownership
- Independent Director Never Previously Employed by Fund Complex
- Mandatory Retirement Policy (including average age and the length of service for Independent Directors)
- Independent Counsel - Independent Director Use of Separate Counsel, Independent Director Reliance on Fund Counsel Different from Adviser's Counsel and Same Counsel for Fund and Adviser with No Independent Counsel
- Audit Committee Financial Expert

### *Other Item of Note*

#### ➤ **Goodwin Procter's ERISA/Employee Benefits Practice Area Issues Update on DOL Final Regulation Concerning Qualified Default Investment Alternatives**

Goodwin Procter's ERISA/Employee Benefit Practice Area issued an Update that discusses a final Department of Labor regulation regarding a safe harbor under ERISA for the investment of plan assets in certain default investment options that qualify as "qualified default investment alternatives." A copy of the Update is available at

<http://www.goodwinprocter.com/~media/517E6707EA5340639B3EEB552135E338.ashx>

