Investment Services Regulatory Update

November 2, 2009

NEW RULES, PROPOSED RULES AND GUIDANCE

Implementation of Identity Theft Prevention Programs Further Delayed Until June 1, 2010

On October 30, 2009, the Federal Trade Commission announced that it would suspend enforcement of the red flags rule under the Fair and Accurate Credit Transactions Act of 2003, which imposes identity theft-related requirements on "financial institutions" and other specified entities, until June 1, 2010. This is the fourth time the FTC has delayed implementation of the rule.

SEC Proposes Amendments to Rules Requiring Internet Availability of Proxy Materials

On October 14, 2009, the SEC proposed changes to the proxy rules to improve the notice and access model for furnishing proxy materials to shareholders. The SEC noted that preliminary data on issuers using the notice-only option under the notice and access model indicated that such issuers had lower shareholder response rates to their proxy solicitations. The proposed amendments would allow issuers additional flexibility in formatting and selecting language to be used in the Notice of Internet Availability of Proxy Materials sent to shareholders as part of the notice-only option. Under the proposed amendments, the proxy rules would identify certain topics required to be covered in the notice, but would not specify the exact language to be used. In addition, to improve shareholder understanding of the notice, the notice could be accompanied with an explanation of the notice and access model.

The proposed rule amendments also seek to make it easier for a soliciting person other than the issuer to use the notice-only option under the notice and access model. Under the current rules, a soliciting person who is not the issuer must send its notice to shareholders either 40 calendar days before the shareholder meeting or 10 calendar days after the issuer first sends its notice or proxy statement to shareholders. The SEC noted that a soliciting person may not be able to send its notice within 10 calendar days after the issuer first sends its notice or proxy statement due to the SEC staff's current practice of reviewing and commenting on proxy materials. To address this issue, the SEC proposed to amend the proxy rules to allow a soliciting person other than the issuer using the notice-only option to timely deliver a notice to shareholders if the soliciting person files a preliminary proxy statement within 10 days of the issuer filing its definitive proxy statement and sends its notice to shareholders no later than the date on which it files its definitive proxy statement.

Comments on the proposals are due by November 20, 2009.

SEC Proposes Rules to Enhance Credit Ratings Disclosure

On October 7, 2009, the SEC proposed amendments to various rules and forms under the 1933 Act, the 1934 Act and the 1940 Act to require registrants to disclose information regarding credit ratings used in connection with a registered offering of securities. The proposed amendments would apply to closed-end funds that use a credit rating with respect to a class of securities issued by the fund. Specifically, the SEC proposed to amend Form N-2 to require additional disclosure about a credit rating used in connection with the offering of a class of securities of a closed-end fund, including disclosure of all material limitations on the scope of the credit rating and disclosure of potential conflicts of interest, including the source of payment for the credit rating. In addition to the disclosure regarding credit ratings included in Form N-2, closed-end funds would be required to disclose any changes to a credit rating that was used with respect to a class of securities issued by the fund. Under the proposed amendments, closed-end funds would be required to file a Form 8-K disclosing the credit rating changes unless substantially similar information as would be required in the Form 8-K was made publicly available through a press release.

Comments on the proposal are due by December 14, 2009.

SEC Removes Rule References to Nationally Recognized Statistical Rating Organizations

On October 5, 2009, the SEC adopted amendments to 1934 Act and 1940 Act rules to remove references to nationally recognized statistical rating organizations ("NRSROs"), as part of the SEC's effort to address concerns that references to NRSROs in SEC rules may have contributed to an undue reliance by market participants on the ratings issued by NRSROs. The changes most relevant for funds are to Rules 10f-3 and 5b-3 under the 1940 Act.

Rule 10f-3 permits a fund that is affiliated with a member of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met. In the rule amendments, the SEC revised the criteria for municipal securities that may be purchased in reliance on the rule by removing references to NRSRO ratings in favor of criteria based upon a particular security's liquidity and credit quality. The process for fund boards approving appropriate procedures and reviewing 10f-3 purchases on a regular basis was not changed by the amendments.

Rule 5b-3 under the 1940 Act relates to Section 5(b)(1) of the Act, which limits the amount that a diversified fund may invest in the securities of any one issuer, other than the U.S. government. For purposes of diversification requirements, Rule 5b-3 equates the acquisition of "refunded securities" (i.e., debt securities whose principal and interest payments are to be paid by U.S. government securities placed in an escrow account) with the acquisition of the escrowed government securities, provided that certain conditions are met. One condition requires funds to obtain an independent accountant's certification relating to refunded securities to be purchased, unless the securities have received a debt rating in the highest category from an NRSRO. In the rule amendments, the SEC eliminated this NRSRO rating exception, and an independent accountant's certification must now be obtained regardless of a refunded security's rating.

The rule amendments are effective on November 12, 2009.

FINRA Requests Comments on Proposed Amendments to Rules Governing Communications With the Public

On September 21, 2009, FINRA issued for comment proposed new rules which would replace current NASD Rules 2210 and 2211, the Interpretive Materials that follow NASD Rule 2210 and portions of Incorporated NYSE Rule 472. In large part, the content of the proposed rules governing member communications with the public mirrors that of the existing rules; however, the six categories of communications provided for in the existing rules would be replaced by three new categories of communications. Furthermore, the proposed rules would revise certain approval, filing and content requirements.

Specifically, FINRA's proposed rules would consolidate the six categories of member communications in NASD Rule 2210 into the following three: (1) institutional communication, which would include communications that fall under the current definition of "institutional sales material," (2) retail communication, which would include any written communication that is distributed or made available to more than 25 existing or prospective retail investors (i.e., communications that currently qualify as advertisements or sales literature), and (3) correspondence, which would include any written communication distributed or made available to 25 or fewer existing or prospective retail customers.

Similar to the existing rules, the proposed rule would require a member firm's registered principal to approve each retail communication before the earlier of its use or filing with FINRA. However, the proposal eliminates the requirement in NYSE Rule 472 that a "qualified person" approve in advance each advertisement, sales literature or other similar type of communication by an NYSE member firm.

The proposed rule would modify the FINRA filing requirements in two respects. First, the requirement to file would cover all retail communications, rather than just advertisements. Second, the proposal would trigger the one-year filing requirement to begin on the effective date a firm becomes registered with FINRA, rather than on the date a communication is first filed with FINRA.

FINRA's proposed rules would expand the current pre-use filing requirements to require the following, among others, to be filed with FINRA at least 10 business days prior to first use: retail communications concerning any registered fund that includes self-created rankings and retail communications that include bond fund volatility ratings. Furthermore, such filings would be withheld from use until any revisions specified by FINRA staff were made. The proposal would also expand the filing requirements for materials relating to closed-end funds to include retail communications distributed after the fund's initial public offering.

FINRA's proposed Rule 2210(d) would reorganize, but essentially incorporate, the current content standards applicable to communications with the public, subject to certain revisions. The content standards that currently apply to advertisements and sales literature generally would apply to retail communications under FINRA's proposed rule. However, based largely on existing FINRA guidance, FINRA's proposal adds requirements concerning comparative illustrations of tax-deferred versus taxable compounding, which would apply to any illustration, regardless of whether it appears in a communication promoting variable insurance products or some other communication, such as one discussing the benefits of investing in a 401(k) plan or individual retirement account.

FINRA's proposal also would revise the current content standards relating to mutual fund performance data. Proposed Rule 2210(d)(5) would revise fund performance communications to require disclosure of the maximum sales charge and total operating expense ratio as reflected in a fund's prospectus or annual report, whichever is more current as of the date the communication is submitted for publication.

To better align with existing regulatory standards, proposed FINRA Rule 2210(d)(7)(C) would amend the current provisions governing communications that include past recommendations to mirror those found under the Advisers Act. In addition, proposed FINRA Rule 2210(d)(7)(D) would expressly exclude from its coverage communications that: (1) meet the definition of "research report" and that include certain disclosures and (2) recommend only registered funds or variable insurance products.

The FINRA proposal would extend the standards for communications that contain a recommendation to retail communications, correspondence and public appearances, and would extend the "fair and balanced" disclosure requirements to associated persons who recommend securities in public appearances (currently the rule only applies to research analysts making public appearances).

The comment period expires on November 20, 2009.

SEC Adopts Rule Requiring Disclosure of Certain Money Market Fund Portfolio Information

On September 18, 2009, the SEC adopted a new rule – effective immediately – requiring money market funds whose net asset value ("NAV") per share falls below $0.9975 to provide portfolio and valuation information to the SEC on a weekly basis for as long as a fund's NAV per share remains below that level. Interim temporary final Rule 30b1-6T, issued in conjunction with the expiration of the Treasury Department's Temporary Guarantee Program for Money Market Funds ("Guarantee Program"), requires funds to provide substantially the same information as was required for funds participating in the Guarantee Program. Money market funds are required to provide detailed information about each security held by the fund no later than the next business day after a fund's NAV per share falls below $0.9975 and then must submit the same information as of the last business day of each week by no later than the second business day of the following week. Upon expiration of the rule, the SEC will consider whether to extend or amend the rule as part of its broader proposed money market reforms.

SEC Proposes Flash Order Ban

On September 17, 2009, the SEC proposed amendments to Regulation NMS that would eliminate the exception for use of flash orders by market participants. Flash orders, which are orders for immediate execution or withdrawal, are currently excepted from the requirement under Regulation NMS that exchanges publicly disseminate their best bids and offers in U.S.-listed equities. If adopted, the elimination of the exception for flash orders would require flash orders with non-marketable prices to be included in the publicly disseminated consolidated quotation data and would prohibit flashing orders with marketable prices only to certain market participants. The SEC's proposing release states that the benefits of flash orders for some market participants do not justify their costs to other market participants, the national market system and the public interest.

Comments on the proposals are due by November 23, 2009.

SEC Proposes Changes to NYSE Corporate Governance Standards

On September 11, 2009, the SEC published for comment proposed changes to certain of the corporate governance requirements in Section 303A of the NYSE's Listed Company Manual. The proposed changes clarify a number of provisions, including the time by which companies listing in conjunction with an initial public offering, spin-off or carve-out must comply with the audit committee requirements, that closed-end funds choosing to include a "Management's Discussion of Fund Performance" must have their audit committee meet to review and discuss it, and that closed-end funds are subject to the provision regarding shareholder approval of equity compensation plans. The changes would eliminate the required annual certification by CEOs that they are not aware of any violations by the company of NYSE listing standards. Instead, revised Section 303A.12(b) would require listed companies to notify the NYSE in writing after an executive officer becomes aware of any non-compliance with Section 303A. Currently, notification is only required for material non-compliance. The changes are proposed to take effect January 1, 2010.

Massachusetts Proposes Amendments to Information Security Program Regulations and Compliance Deadline

On August 17, 2009, the Massachusetts Office of Consumer Affairs and Business Regulation published for comment proposed amendments to the regulations that require persons (including funds) who own or license personal information about a Massachusetts resident, such as a shareholder or employee, to develop, implement and maintain a comprehensive, written information security program, including a computer security system program. Under the amended regulations, "owns or licenses" is defined to include receiving, processing or otherwise accessing personal information. The revised regulations set forth a risk-based approach to information security, reflect that a number of the specific provisions previously required to be in the information security program were removed, apply technical feasibility to the computer security requirements and make the third-party vendor requirements consistent with federal law. The deadline for compliance with the proposed amended regulations is March 1, 2010.

NEW LEGISLATION

House Financial Services Committee Approves Private Fund Adviser Registration

On October 27, 2009, the House Financial Services Committee passed the "Private Fund Investment Advisers Registration Act of 2009," which will require investment advisers of certain unregistered investment companies (i.e., 3(c)(1) and 3(c)(7) funds) to register with and provide information to the SEC. Similar legislation was introduced in the Senate and referred to the Committee on Banking, Housing, and Urban Affairs in June 2009.

OTHER NEWS

IDC Issues Task Force Report on Board Oversight of Fund Compliance

On September 10, 2009, the Independent Directors Council issued a task force report entitled "Board Oversight of Fund Compliance." The report discusses the variety of ways in which funds have implemented their compliance programs, as required by Rule 38a-1 under the 1940 Act, and suggests certain core characteristics of a successful compliance function. The goal of the report is to provide a comparative tool, by highlighting various alternatives and practices, that will assist boards in evaluating fund compliance programs.

The report discusses the following common themes amongst fund groups regarding the mission and philosophy of compliance: (1) a fund board can have a significant and immediate influence in defining the goals and priorities of the fund's compliance function; (2) compliance responsibility should be allocated to each business unit that makes up the fund's or adviser's compliance operation; (3) compliance should be structured as a collaborative function that enhances operations and controls, and not structured to punish outliers; and (4) compliance should be proactive, anticipatory and seek to educate all personnel who contribute to its effectiveness.

The report also discusses matters relating to the fund CCO, including considerations regarding the employment of the CCO (e.g., whether the fund CCO should be the same as the adviser's CCO), as well as the CCO's relationship with management and the fund board.

Finally, the report lists the following characteristics that the task force believes support a strong compliance regime: (1) a strong "tone from the top" (i.e., management and the fund's board); (2) the CCO operating in a collaborative manner allows the CCO to undertake his or her role and responsibilities professionally and effectively; (3) a continuous and thoughtful risk-based program; (4) transparency and candor in compliance disclosure between the CCO, the board and management; and (5) effective compliance personnel (including the CCO), armed with appropriate resources.

SEC Provides No-Action Relief Permitting Foreign Funds to Invest in U.S. Funds in Excess of 1940 Act Limitations

On August 4, 2009, the SEC staff issued a no-action letter stating that it would not recommend enforcement action against a foreign fund that acquires shares of a registered U.S. fund in excess of the 5% and 10% anti-pyramiding limitations of Section 12(d)(1)(A) of the 1940 Act.

In granting the relief, the SEC staff relied on the following representations:

- each foreign fund will comply with the 3% restrictions of Section 12(d)(1)(A) of the 1940 Act;
- each foreign fund will not offer or sell securities in the U.S. or to any U.S. person;
- each foreign fund's transactions with its shareholders will be consistent with the definition of "offshore transactions" in Regulation S under the 1933 Act; and
- each U.S. fund will comply with the restrictions of Section 12(d)(1)(B) of the 1940 Act.

ENFORCEMENT ACTIONS

FINRA Settles Auction Rate Securities Violations with Three Firms

On September 2, 2009, FINRA announced that it had entered into final settlement agreements with Northwestern Mutual Investment Services, LLC, City Securities Corporation and Fifth Third Securities to settle charges relating to the sale of Auction Rate Securities ("ARS"). Each of the firms agreed to initiate or complete offers to repurchase ARS sold to their customers in connection with failed ARS auctions.

According to FINRA, its investigation of the firms uncovered evidence that each firm employed the use of unfair and unbalanced advertising, marketing materials or other communications in its efforts to sell ARS, and did not provide investors with a sound basis on which to evaluate the benefits and risks of investing in ARS. Moreover, FINRA's investigation of the firms revealed that each firm failed to maintain adequate supervisory systems reasonably designed to achieve compliance with the securities laws and FINRA rules with respect to the marketing and sale of ARS.

Under the terms of the agreements, each firm will offer to repurchase at par value certain outstanding ARS purchased by investors between May 31, 2006, and February 28, 2008. As a result, a total of approximately $128 million of ARS are eligible for repurchase. Additionally, the firms have agreed to compensate individual investors who sold ARS below par after February 28, 2008 and pay fines totaling $600,000. Going forward, any additional claims against the firms for consequential damages resulting from investors' inability to access funds invested in ARS will be resolved by an independent, non-industry arbitrator.

SEC Charges Adviser and Its CEO for Fraudulently Overstating Assets

On August 13, 2009, the SEC charged Brantley Capital Management ("BCM"), investment adviser to Brantley Capital Corporation (a business development company) ("BCC"), and Robert Pinkas, chief executive officer of BCM, with securities fraud for overvaluing assets held by BCC in order to generate higher investment advisory fees.

According to the SEC, Mr. Pinkas and Tab Keplinger, BCM and BCC's part-time chief financial officer, substantially overstated the value of equity and debt investments in two failing private companies that represented more than half the investment portfolio of BCC, including equity of a private airline. The SEC alleged that Mr. Pinkas and Mr. Keplinger understood that the airline faced severe financial difficulties, and Mr. Pinkas knew that it was able to remain in business only because another investor repeatedly loaned the company money, yet Mr. Pinkas and Mr. Keplinger failed to disclose these financial difficulties to BCC's board and investors. The two also allegedly misrepresented the financial performance of the airline to BCC's board and its independent auditors, cited various false rationales to support their $32.5 million valuation, and concealed third-party valuations that indicated BCC's investment was worth substantially less than what was being represented.

The SEC also alleged that the value of debt investments in another company was overstated. According to the SEC, Mr. Pinkas and Mr. Keplinger repeatedly advised BCC's board that the company would repay most of the loans provided by BCC, when in fact the company could not repay the loans. In addition, the company consistently missed its financial targets by large margins, remained in business only because BCC continued to loan it money, and lacked sufficient assets to cover BCC's loans in the event of liquidation. Despite knowing these facts and that the BCC's loans to the company were essentially worthless, Mr. Pinkas and Mr. Keplinger allegedly advised BCC's board that only relatively minor write-downs were required.

Mr. Keplinger agreed to settle the SEC's charges without admitting or denying the allegations and agreed to a $50,000 penalty and certain industry and professional bars. Mr. Pinkas and BCM are contesting the SEC's charges.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.