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Developments of Note

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➢ SEC Votes to Propose Guidance for Fund Boards in Overseeing Best Execution and Adviser Soft Dollar Usage

At its open meeting last week, the SEC voted to propose guidance for registered fund directors regarding their oversight of fund portfolio transaction activity, including soft dollar use by fund advisers. The soft dollar portion of the release appears designed to fulfill commitments made by the SEC at the time it issued interpretive guidance on the safe harbor under Section 28(e) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), that it would also provide guidance to assist fund directors in overseeing adviser soft dollar use. While the release proposing the guidance (the "Proposing Release") states that it would not impose any new or additional requirements, the proposed guidance includes a number of prescriptions and suggestions for board and adviser action relating to best execution and soft dollar use that would likely have a noticeable impact in framing board and adviser conduct in these areas if the proposed guidance is issued in final form. The Proposing Release provides a fairly extensive description of fund boards' general fiduciary responsibilities before discussing their specific responsibilities with respect to fund portfolio transaction activity, which are presented as arising in three principal contexts – general ongoing oversight, approval/review of compliance programs and advisory contract approval. Although not given the same degree of emphasis as ensuring best execution and appropriate soft dollar usage, the Proposing Release also addresses general control over transaction costs as a goal of board oversight of fund portfolio transaction activity, *i.e.*, ensuring that the level of portfolio turnover is not excessive.

Best Execution. The Proposing Release summarizes past SEC guidance defining a fund adviser's duty of best execution. It also discusses board consideration of an adviser's use of alternative trading systems, noting that while use of these trading venues may offer potential benefits like lower costs they may not be appropriate for all funds or in all circumstances. In evaluating an adviser's efforts to achieve best execution, the proposed guidance recommends that a fund board request the following data: "(i) the identification of broker-dealers to which the adviser has allocated fund trading and brokerage, (ii) the commission rates or spreads paid, (iii) the total brokerage commissions and value of securities executed that are allocated to each broker-dealer during a particular period, and (iv) the fund's portfolio turnover rates."

The Proposing Release also lists the following topics for fund boards to discuss with fund advisers, as applicable:

"▪ The process for making trading decisions and the factors involved in the selection of execution venues and the selection of broker-dealers;

- The means by which the investment adviser determines best execution and evaluates execution quality as well as how best execution is affected by the use of alternative trading systems;
- Who negotiates commission rates, how that negotiation is carried out, whether the amount of commissions agreed to depends on comparative data with respect to commission rates, and generally how transactions costs are measured;
- How the quality of "execution-only" trades – trades that do not include payment for any additional research or services beyond execution – is evaluated compared to that of other trades (for example, whether trades that are executed through channels that include an additional soft dollar component are reviewed in comparison with execution-only trades to discern any discrepancies in the quality of execution);
- How the performance of the adviser's traders is evaluated, as well as the aggregate performance of the firm's traders as a whole, how the performance of each broker-dealer the adviser uses for fund portfolio transactions is evaluated, and how problems or concerns that are identified with a trader or a broker-dealer are addressed;
- If sub-advisers are used, how the adviser provides oversight and monitors each sub-adviser's activities, including the trading intermediary selection process;
- To what extent and under what conditions the adviser conducts portfolio transactions with affiliates;
- The process for trading fixed-income securities and determining the costs of fixed income transactions;
- How the quality of trade execution is evaluated with respect to fixed-income and other instruments traded on a principal basis; and
- If there are international trading activities, how these trades are conducted and monitored."

The proposed guidance also indicates that fund boards need to stay abreast of industry developments in trading and lists the following methods boards have to used to educate themselves in this area:

"(1) establishing a committee of the board to specialize in portfolio trading practices;

(2) requiring that the adviser form special committees to consider best execution and the use of client commissions and to provide reports to the board on the adviser's trading activities;

(3) requesting periodic summaries and analyses from officers of the adviser to explain the adviser's portfolio trading practices;

(4) attending trade association events, seminars and/or other education events relating to brokerage practices;

(5) subscribing to third-party information providers or retaining experts to ensure that board members remain knowledgeable with respect to market developments; and

(6) periodically meeting with portfolio managers, business unit staff, trading personnel and other employees of the adviser."

Soft Dollars. The Proposing Release frames a fund adviser's use of soft dollars, *i.e.*, the use of commissions paid on fund portfolio transactions to purchase research and brokerage in accordance with the safe harbor of Section 28(e) of the 1934 Act, in the broader context of using commissions on fund portfolio transactions for purposes other than for pure execution, including participation in commission recapture programs that provide rebates or pay fund service provider expenses. Under the proposed guidance, a fund board should request information on the following:

"▪ How does the adviser determine the total amount of research to be obtained and how will the research actually be obtained? In particular:

- › How does the adviser determine the amount to be spent using hard versus soft dollars?
- › How does the adviser determine amounts to be spent on proprietary versus third-party research arrangements?
- › What types of research products and services will the adviser seek to obtain and how will this research be beneficial to the fund?
- › How does the adviser determine amounts to be used in commission recapture programs and expense reimbursement programs?

- ▪ What is the process for establishing a soft dollar research budget and determining brokerage allocations in the soft dollar program? Is a broker vote process or some other mechanism used? [In a broker vote process, an adviser polls its portfolio managers and analysts regarding the quality of broker-dealer research and other services.]
- ▪ Do any alternative trading venues that are used produce soft dollar credits? If so, how much?
- ▪ How does the adviser determine that the use of soft dollars is within the Section 28(e) safe harbor? In particular:
  - › Is the product or service obtained eligible brokerage or research, as defined under section 28(e)?
  - › Does the product or service provide lawful and appropriate assistance to the adviser in carrying out its investment decision-making responsibilities?
  - › Is the amount of commissions paid reasonable (based upon a good faith determination) in light of the value of brokerage and research services provided by the broker-dealer?
- ▪ How does soft dollar usage compare to the adviser's total commission budget?
- ▪ How are soft dollar products and services allocated among the adviser's clients? Are the commissions paid for certain trades in fund portfolio securities similar to commissions paid for transactions in similar securities, or of similar sizes, by the fund and the adviser's other clients

(including clients that are not funds)? Are other clients paying lower commissions that do not include a soft dollar component? If so, does the adviser adequately explain the discrepancy in commission rates and provide the board data sufficient to satisfy the board that the fund is not subsidizing the research needs of the adviser's other client? To what extent are the products and services purchased through soft dollar arrangements used for the benefit of fixed-income or other funds that generally do not pay brokerage commissions?

- What is the process for assessing the value of the products or services purchased with soft dollars?
- What is the process used to evaluate the portion of a mixed use product or service that can be paid for under section 28(e)?
- To what extent does the adviser use client commission arrangements? What effect do these arrangements have on how the adviser selects a broker-dealer to complete a particular transaction? How does the adviser explain that the use of client commission arrangements benefits the fund?"

The proposed guidance would also have fund boards consider "(i) whether it is appropriate for the adviser to refrain from purchasing research services in connection with certain types of trades, depending on market conditions; (ii) whether it is appropriate for the adviser to use fund brokerage commissions to receive brokerage and research services on some or all trades; (iii) whether fund brokerage commissions should be used only in connection with a commission recapture or expense reimbursement program; and (iv) whether some combination of these alternatives may be in the best interest of the fund."

Board Evaluation and Action. Under the proposed guidance, a fund board would need to evaluate an adviser's pursuit of best execution and use of soft dollars in terms of the best interest of the fund, and in each instance, would need to address with the adviser instances where it fell short of this standard. The Proposing Release notes that where an adviser's use of brokerage commissions is not in a fund's best interest, "the board should prohibit or limit the use of fund brokerage commissions and direct the adviser accordingly." In this regard, the Proposing Release points out that Section 28(e) states that its safe harbor does not apply "where expressly provided by contract."

Advisory Contract Approval. The SEC proposes less extensive guidance in the context of the advisory contract renewal process where consideration of "fall out benefits" to an adviser such as soft dollar research and brokerage are one of the factors cited in the leading cases deciding excessive advisory fee claims under the 1940 Act and in fund shareholder report disclosure requirements regarding advisory contract approvals. Noting a wide range of practice in this area, the proposed guidance indicates that "fund directors should require investment advisers, at a minimum, to provide them with information regarding the adviser's brokerage policies, and how a fund's brokerage commissions, and, in particular, the adviser's use of soft dollar commissions, were allocated, at least on an annual basis. . . . Fund directors should, for example, consider whether the adviser properly accounts for use of fund brokerage commissions to purchase research that primarily or solely benefits another client of the adviser."

Additional Soft Dollar Disclosure Requirements. After noting changes in soft dollar disclosure it has already proposed for Form ADV Part 2 (as discussed in the April 22, 2008 *Alert*), the Proposing Release solicits comment on whether it should take further action on soft dollars disclosure with respect to fund investors to provide them with (i) the same kind of information the SEC proposes fund boards consider and (ii) specific disclosure to inform their investment decisions. The Proposing Release also seeks comment on (a) whether the public dissemination of particular information regarding a fund adviser's portfolio trading practices would have an adverse impact on the adviser's relationships with the broker-dealers that execute fund portfolio transactions and (b) whether the SEC should again consider proposing that investment advisers provide their clients with customized information about how their individual brokerage is being used.

Public Comment. Comments on the Proposing Release are due by October 1, 2008.

➢ IRS Issues Guidance Regarding the Deductibility of Management Fees of a Fund of Funds

The Internal Revenue Service (the "IRS") released Rev. Rul. 2008-39, which relates to the deductibility of management fees paid by an upper-tier partnership and allocable to a U.S. individual investor in a fund of funds.

The ruling addresses the federal income tax consequences to an individual taxpayer who invests in an upper-tier partnership that holds limited partnership interests in various lower-tier partnerships, each of which engages in the business of trading stocks and securities for its own account. The issue is whether individual taxpayers may deduct their share of the management fees paid by the upper-tier partnerships as a business expense or as an investment expense. Generally, an item that is deductible as investment expense rather than as business expense is less advantageous to a U.S. individual taxpayer because an investment expense item is taken into account only if it and other miscellaneous itemized deductions exceed 2% of the taxpayer's adjusted gross income, whereas a business expense item reduces the gross income of a taxpayer without such limitation. The IRS ruled that the management fees paid by the upper-tier partnership is an investment expense, because the activities of the upper-tier partnership do not constitute a trade or business, but merely the holding of limited partnership interests in the lower-tier partnerships for the production of income. Thus, an individual investor in a fund of funds structure will be able to deduct an allocable portion of the management fees paid at the upper-tier partnership level only if such amount and other miscellaneous deductions exceed 2% of the individual's adjusted gross income. One silver lining of the ruling is that the IRS confirmed that the management fees paid by a lower-tier partnership constitute a business expense that is taken into account in computing the lower-tier partnership's taxable income or loss.

Although Rev. Rul. 2008-39 addressed a fund of funds structure, it also may have implications for master-feeder structures with multiple tiers of partnerships if upper-tier/feeder-level partnerships bear separate management fees. In light of Rev. Rul. 2008-39, funds that use master feeder structures and wish to minimize the adverse tax consequences to U.S. individual investors may need to re-structure the management fees, so that such fees are paid at the lower-tier levels, where the actual trading activities occur.

➢ FINRA Proposes To Update and Consolidate Rules Governing Marketing of Variable Annuities and Variable Life Insurance

FINRA issued a Regulatory Notice that proposes to update and consolidate the guidelines on illustrations of tax-deferred versus taxable compounding in advertising and sales literature (NASD Interpretive Material 2210-1) and communications with the public about variable life insurance and variable annuities (NASD Interpretive Material 2210-2). The proposed changes would:

- shorten and simplify existing provisions regarding product identification, liquidity and guarantee claims;
- consolidate previous FINRA staff guidance concerning variable insurance product communications;
- address changes in variable insurance products and the manner in which they are advertised, particularly with regard to riders, hypothetical illustrations and investment analysis tools; and
- codify FINRA staff guidance concerning comparative illustrations of the mathematical principle of tax-deferred versus taxable compounding.

Although the revised rules would in many cases simply clarify existing rules and codify existing staff positions, the proposed rules would limit to 10% the assumed rates of return used in hypothetical illustrations and would alter the requirements for single-customer illustrations using the weighted average of underlying fund expenses.

The comment period on the proposal expires September 30, 2008.

➢ SEC and DOL Enter Into Information-Sharing Memorandum of Understanding to Formalize Regulatory Cooperation

Cementing existing information-sharing and increasing collaboration in the area of retirement plans, the SEC and the Department of Labor ("DOL"), signed a Memorandum of Understanding ("MOU") on July 29, 2008, which allows for a more streamlined system of sharing information between the agencies in examinations, investigations and enforcement proceedings concerning "matters of mutual interest." The MOU, which will be in effect for five years, reflects the current practice of sharing information between the SEC and the DOL's Employee Benefits Security Administration, but sets up a more formalized framework for: (1) regular meetings to discuss trends, exam findings, regulatory requirements and enforcement cases; (2) points of contact at each regulator's regional offices; (3) cross-training in each agency's mission and investigative jurisdiction; (4) DOL access to non-public SEC exam information; (5) SEC and DOL access to non-public enforcement information of both agencies; and (6) ensuring confidentiality and protection of privilege. As discussed in the July 8, 2008 *Alert*, the SEC has signed a similar MOU agreement with the FRB, and announced in March that it had done so with the CFTC. Because the DOL/SEC MOU largely memorializes existing practice, particularly in proceedings following the collapse of Enron and the subprime and credit market dislocation, change may not be immediately apparent to regulated entities. A copy of the press release and MOU are available through the SEC's web site at http://sec.gov/news/press/2008/2008-154.htm.

➢ SEC Staff Grants No-Action Relief to Permit Fund to Rely on Rule 15a-4 under the 1940 Act to Enter into Interim Sub-Advisory Contract Following Sub-Adviser Resignation

The staff of the SEC's Division of Investment Management granted no-action relief to permit a registered closed-end fund (the "Fund") to enter into an interim sub-advisory contract that otherwise complies with the requirements of Rule 15a-4 under the Investment Company Act of 1940, as amended (the "1940 Act"), even though the resignation of the Fund's sub-adviser that created the need for an interim agreement is not one of the circumstances in which the Rule would be available. Rule 15a-4 allows a 150 day grace period following the termination of a fund advisory/subadvisory contract to secure the shareholder approval of a successor advisory/subadvisory contract required under Section 15 of the 1940 Act. By its terms, Rule 15a-4 is available only when the predecessor contract was terminated (a) by the fund's board of directors or by its shareholders, (b) by a failure to renew the predecessor contract or (c) by an assignment of the predecessor contract within the meaning of the 1940 Act. The circumstances prompting the request for relief in this instance were that on June 2, 2008 the Fund's sub-adviser tendered its resignation effective July 31, 2008. Neither the Fund nor its investment adviser anticipated this development which was prompted by the sub-adviser's determination following an internal review of its personnel and resources that it was in the sub-adviser's and the Fund's best interests that it resign. Rule 15a-4 imposes one set of conditions if the engagement of a successor adviser involves any money or other benefit being received by the predecessor adviser or any of its controlling persons, and another if the successor adviser's engagement does not. Under the no-action relief, the Fund, its investment adviser and the successor sub-adviser must determine based on their particular facts and circumstances which set of conditions would apply under Rule 15a-4 and comply with those conditions.

➢ FASB Delays Effective Date for Revised FAS 140 Concerning Securitizations

The Financial Accounting Standards Board ("FASB") delayed the effective date for its amendments (the "FAS 140 Amendments") to Financial Accounting Standards No. 140 – *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* ("FAS 140") from January 1, 2009 to January 1, 2010. The FAS 140 Amendments would reduce banks' ability to get "sale" accounting treatment when they securitize loans (including, *e.g.*, mortgage-backed securities, auto loans and credit card loans) and, accordingly, would reduce banks' ability to transfer these loans off their balance sheets. Prior to the effective date of the FAS 140 Amendments, FASB must issue a proposed version of the FAS 140 Amendments and, after a public comment period, approve and issue a final version of the FAS 140 Amendments.

➢ OTS Amends Mutual Holding Company Regulations Applicable to Minority Stock Ownership Limitations of MHC Subsidiaries

The OTS published a final rule amending its mutual holding company regulations to permit certain mutual holding company ("MHC") subsidiaries to adopt an optional charter provision that would prohibit any person from acquiring, or offering to acquire, beneficial ownership of more than ten percent of the outstanding stock of any class of voting stock of the institution during the five years following a sale by the subsidiary of less than 50 percent of its voting stock to parties other than the top-tier MHC (a "minority stock issuance"). The optional charter provision may be adopted only by (a) a MHC subsidiary or (b) where there is no MHC subsidiary, by a former mutual savings association that reorganized into an MHC structure.

The regulations, which amend 12 C.F.R. §§ 575.9 and 575.14, are designed to prevent minority stockholders of a MHC subsidiary from exerting too much influence over the institution in the first years after a minority stock issuance. In particular, the OTS expressed concern about several situations in which minority stockholders have taken actions that apparently were intended to force management to engage in stock repurchases or in a sale of the institution, based on their ability to vote on issues that must be presented separately to minority stockholders. Accordingly, the implementing release states that the new regulations will allow institutions to adopt the optional charter provision in order to lessen their vulnerability to attempts by minority stockholders to take unfair advantage of the results of a minority stock issuance, and thereby ensure that such offerings are completed in a manner that strengthens the issuer. The final rule is effective on October 1, 2008.

➢ American Bankers Association Seeks to Protect Bank Interest Expense Deduction

The Treasury Department recently released to the public a letter from the American Bankers Association (the "ABA") that urged the Treasury Department to carve out an exception for banks if it proposes rules that would bar the tax treatment allowed by the Tax Court in *PSB Holdings Inc. v. Commissioner*, 129 T.C. 131 (2007). The ABA's letter was prompted by the Treasury Department's release of its periodic update of the 2007-2008 Priority Guidance Plan, indicating that it is considering issuing proposed regulations that would seek to overturn the *PSB Holdings* decision.

The issue in *PSB Holdings* was whether the tax-exempt assets held by an investment subsidiary of a bank have to be counted as the parent bank's assets in computing the amount of interest expense disallowed under Section 265(b) of the Internal Revenue Code. The Tax Court ruled that they do not. The Tax Court's holding in *PSB Holdings* rejected the position the IRS had announced in Revenue Ruling 90-44 and represented a major victory for the banking industry. Under Section 265(b), a bank generally may not deduct interest expense allocable to tax-exempt interest from tax-exempt obligations. The IRS issued Revenue Ruling 90-44 to simplify the application of Section 265(b) and to prevent banks from transferring tax-exempt obligations to wholly owned subsidiaries and replacing the tax-exempt obligations with the stock of the subsidiary as the asset of the bank that bears the interest expense.

In its letter to the Treasury Department, the ABA raised the concern that the Treasury Department may be drafting a rule that would require a consolidated approach to deductions. It urged the Treasury Department to provide an exception that would allow banking firms to carry or purchase tax-exempt obligations as long as no borrowed funds are used to do so and stated that such an exception would be consistent with the Congressional intent to maintain equality between banks and non-banks in the application of the interest expense disallowance rules relating to tax-exempt obligations.

Other Items of Note

➢ Goodwin Procter Sponsors Seminar on Private Equity Investing in Banks

With the capital markets in a state of transition and banks, in particular, looking for new sources of capital, our latest M&A event couldn't come at a more opportune time. Held in New York on Oct. 2, ***Private Equity Investing in Banks: Opportunities in a Perfect Storm*** will examine the latest trends in this sector of the M&A market as regulators consider ways to alleviate the burden of private equity investing in banks. Several private equity funds are being raised to invest in the banking industry, while a growing number of banking institutions are considering acquisitions, selling minority stakes or putting themselves up for sale.

Join some of the biggest names in the industry on October 2, at the Le Parker Meridien in New York City and hear from experts from both the M&A and banking communities. Anchored by keynote speaker **Randy Quarles, Managing Director** with **The Carlyle Group**, and former Under Secretary of the Treasury, our panel will provide insights into this evolving sector. You will have ample opportunities for both learning and networking with bank executives, private equity firms, hedge funds and investment banks.

For more information or to register, click here: http://www.sourcemediaconferences.com/FMA08/

➢ SEC Staff Issues Second ComplianceAlert Summarizing Examination Findings

The staff of the SEC's Office of Compliance Inspections and Examinations ("OCIE), has issued a second ComplianceAlert, the first being issued in June 2007, that summarizes select areas that SEC examiners have recently reviewed during examinations. As in the previous year, the ComplianceAlert also provides perspective on industry practice in certain areas without commenting on whether the practices are necessary to meet applicable legal requirements in any instance. The specific areas covered in the ComplianceAlert regarding investment advisers/mutual funds were (a) personal trading by adviser personnel, including an extensive list of practices thought to be effective, (b) proxy voting and use of proxy voting services, (c) valuation and liquidity issues for high yield municipal bond funds and (d) soft dollar practices, including information on a range of practices observed. The broker-dealer topics were (1) "free lunch" sales seminars, (2) valuation and collateral management processes, (3) broker-dealer subsidiaries of insurance companies, (4) supervision of registered representatives designated as "solicitors" for an investment adviser, (5) recommendations to finance securities purchases through mortgage financing and (6) supervisory and compliance controls under an Office of Supervisory Jurisdiction structure. The ComplianceAlert topic also discussed transfer agent practices in fulfilling their obligation to search for lost securityholders.

➢ Independent Directors Council Issues Report on Oversight of Derivative Investments by Registered Fund Boards

The Independent Directors Council issued another in its series of reports addressing areas of particular interest for the directors of registered investment companies, this one concerning oversight of fund investments in derivatives. The report discusses (a) board oversight responsibilities for fund investments in derivatives, (b) definitions and primary categories of derivatives, (c) portfolio management applications, risks, and controls for fund investments in derivatives, (d) operational and regulatory considerations for fund investments in derivatives and (e) related board practices and resources. A significant portion of the report is devoted to appendices that present topics for discussions between fund boards and advisers regarding derivatives investments, and provide a glossary of terms, examples of derivatives applications, and references to additional educational resources.

➢ SEC Reopens Comment Period on Mutual Fund Summary Prospectus Proposal

The SEC reopened the comment period on its summary prospectus proposal for mutual funds, which was discussed in detail in a December 2007 Client Alert (available at Client Alert - Summary Prospectus Proposal), in order to allow comment on the results of (a) focus group testing regarding various aspects of the proposal and (b) a telephone survey of investor views on disclosure documents. The focus group and telephone survey results along with related documents are available at Focus Group and Survey Results. The reopened comment period extends through August 29, 2008. The release reopening the comment period is available at SEC Release