September 19, 2011

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SEC Rules and Regulations

SEC Requests Public Comment on the Use of Derivatives by Mutual Funds and Other Investment Companies

On August 31, 2011, the SEC issued a concept release (the "**Derivatives Concept Release**") soliciting public comment on the use of derivatives by registered investment companies under the Investment Company Act of 1940 (the "**Investment Company Act**"). The SEC is seeking public comment to assist its review of the use of derivatives by management investment companies registered under the Investment Company Act and companies that have elected to be treated as business development companies under the Investment Company Act (collectively, "**funds**"), with the goal of evaluating whether the regulatory framework, as it applies to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Investment Company Act and is consistent with investor protection. The issuance of the concept release is part of an ongoing review by the SEC of funds' use of derivatives under the Investment Company Act. For a discussion of other recent SEC reviews, including that of derivatives-related disclosure by investment companies, see the ***May 8, 2009, April 6, 2010, May 10, 2010 and August 16, 2010 Investment Management Regulatory Updates***.

Specifically, the Derivatives Concept Release seeks public comment on several issues relating to funds' use of derivatives, including: (i) the attendant costs, benefits and risks of such use; (ii) the application of the Investment Company Act's prohibitions and restrictions on senior securities and leverage, as well as current SEC guidance on the use of segregated accounts to "cover" senior securities; (iii) the application of the Investment Company Act's limits on investments in securities-related issuers; (iv) the application of the Investment Company Act's provisions concerning portfolio diversification and concentration (including valuation of derivatives for purposes of determining a fund's diversification classification); (v) the application of the Investment Company Act's provisions regarding valuation of funds' assets and (vi) any other matters relevant to the use of derivatives by funds. A summary of the major issues for which the SEC requests public comment is set forth below:

Application of the Investment Company Act's prohibitions and restrictions on senior securities and leverage

Section 18 of the Investment Company Act imposes limitations on funds' issuance of senior securities, generally prohibiting, among other things, a fund from issuing or selling any senior security representing indebtedness unless it maintains 300% asset coverage. The SEC and its staff have long taken the position that many derivatives should be treated as senior securities in light of the inherent leverage they provide. Surveying the applicable SEC and staff guidance, the Derivatives Concept Release noted that, as an alternative to complying with the 300% asset coverage requirement for derivatives, funds are permitted instead to "cover" such senior securities by maintaining segregated accounts containing liquid assets (including equity securities and non-investment grade debt securities) "equal to the indebtedness" incurred by the fund in connection with the senior securities (the "**segregated account approach**"). In determining the amount of assets to be segregated, the SEC stated that it has "generally looked to [(i)] the purchase or exercise price of the contract (less margin on deposit) for long positions and [(ii)] the market value of the security or other asset underlying the agreement for short positions, measured by the full amount of the reference asset, *i.e.*, the notional amount of the transaction rather than . . . its current mark-to-market value." The SEC further noted that, with respect to cash-settled futures, forwards and swaps, funds have segregated an amount equal to the their "daily mark-to-market liability" under such agreements.

In the Derivatives Concept Release, the SEC noted criticism of both the notional amount and mark-to-market approaches to determining asset segregation amounts, and the consideration of alternative methods. Under an alternative approach proposed by the 2010 ABA Derivatives Report, individual funds would establish their own asset segregation standards for certain derivative instruments. In developing these standards, fund investment advisers could take into account a variety of risk measures and would not be limited to notional or mark-to-market standards. These standards would be reflected in policies and procedures that would be subject to approval by the fund's board of directors and disclosed in the fund's statement of additional information. The SEC also cited a number of alternative approaches adopted by non-U.S. jurisdictions, including an approach set out in the Committee of European Securities Regulators' ("**CESR**") (now known as the European Securities and Markets Authority) Global Exposure Guidelines for Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), which subjects derivatives investments by UCITS to a "global exposure" limitation, whereby a derivatives exposure of a UCITS (which a UCITS may measure by either a commitment approach or a maximum potential loss approach) may not exceed the total net value of the UCITS' portfolio. The CESR approach further requires UCITS to follow "cover rules" to permit a UCITS to be capable of meeting its payment and delivery obligations under a derivative at all times. According to the SEC, the Monetary Authority of Singapore utilizes an approach similar to the CESR global exposure requirements whereby it requires that the risks of derivatives used by investment companies be "duly measured, monitored and managed on an ongoing basis." Other alternative approaches, including that of the Central Bank of Ireland and Canadian Securities Administrators, according to the Derivatives Concept Release, limit aggregate exposure and/or require maintenance of liquid assets equal to the notional or exercise value of derivatives contracts. A differentiated approach is applied by the Hong Kong Securities and Futures Commission, according to the Derivatives Concept Release, which limits "investment companies generally to the use of derivatives for non-hedging positions that are capped at" differing percentages of NAV, depending on the type of derivative and strategy in question.

The SEC requests extensive public comment regarding its current approach to the application of the senior securities limitations of Section 18 of the Investment Company Act to funds' use of derivatives and ways in which its current approach could be "improved to better serve the statutory purposes and protect investors." Questions raised for comment by the SEC include whether:

- the SEC's definition of leverage is "sufficiently precise" and appropriate to limiting the risks addressed by the senior security restrictions of Section 18;

- the segregated account approach adequately addresses investor protection concerns and whether the approach creates particular impediments for certain types of funds or strategies;
- owning, or having the right to obtain, the cash or other assets that a fund obligates itself to deliver in connection with senior securities is an adequate substitute for segregation of assets;
- any alternative methods to the segregated account approach should be considered, including the approach proposed by the 2010 ABA Derivatives Report, the bifurcated approach set out in CESR's Global Exposure Guidelines and other alternatives;
- the costs and benefits of utilizing a Value at Risk approach or other comparable risk measurement methodology and whether a stress testing requirement should be imposed on funds that use derivatives; and
- any alternative approaches to the regulation of leverage under the Investment Company Act.

Application of the Investment Company Act's prohibition on investments in securities-related issuers

Under Section 12(d)(3) of the Investment Company Act, funds generally may not purchase or otherwise acquire any security issued by (or any other interest in) the business of a broker, dealer, underwriter, or investment adviser (a "**securities-related issuer**"). A limited exception from this prohibition is Rule 12d3-1 under the Investment Company Act, which states that a fund may acquire securities of any person that, in its most recent fiscal year, (i) derives 15% or less of its gross revenues from securities related activities, so long as the fund does not control such person after the acquisition, or (ii) derives in excess of 15% of its gross revenue from securities related activities, subject to certain limits on the amount of the issuer's securities that a fund may acquire. The SEC noted that when a fund invests in an OTC derivative, if the fund's counterparty is a securities-related issuer, the fund's transaction with the counterparty may be deemed an acquisition of a security issued by, or an interest in, that issuer under certain circumstances.

The SEC is seeking public comment on the application of Section 12(d)(3) and Rule 12d3-1 to fund's derivatives transactions, including whether:

- OTC derivative transactions between funds and securities-related issuers implicate the purposes of Section 12(d)(3);
- a fund's exposure to price movements or performance of a reference security issued by a securities-related issuer implicates the purposes of Section 12(d)(3);
- the extent to which the securities-related issuer's obligations are secured by collateral provided by the issuer should affect the analysis; and
- Rule 12d3-1 is the appropriate framework for exempting certain derivatives transactions from Section 12(d)(3).

Application of the Investment Company Act's provisions concerning portfolio diversification and concentration

Diversification. Under the Investment Company Act, a fund is required to disclose in its registration statements whether it is classified as diversified or non-diversified. According to the SEC, a diversified fund is a fund that, with respect to 75% of the value of its total assets, has (among other things) no more than 5% of the value of its total assets in the securities of any one issuer. A non-diversified fund is any fund that does not meet these requirements.

The SEC stated that a diversified fund investing in derivatives must consider how to value these instruments for purposes of calculating its total assets and whether it has invested 5% of such value in the securities of any one issuer. Currently under the Investment Company Act's valuation provisions, according to the Derivatives Concept Release, a fund investing in derivatives generally uses a market value measure for exchange-traded derivatives and a fair value measure for OTC derivatives; under either approach, according to the Derivatives Concept Release, the value of the derivative would generally be a mark-to-market value. The SEC noted in the Derivatives Concept Release that the use of mark-to-market values for derivatives held by a fund could result in heightened exposure to one or a few issuers, because "mark-to-market values at a given point do not reflect the asset base on which futures gains and losses will be based or otherwise represent the potential future exposure of the fund." For example, the SEC noted, use of a mark-to-market value could allow a fund to maintain an ongoing exposure to a single issuer or group of issuers in excess of the 5% of the fund's assets on a notional basis, while continuing to be classified as diversified. The SEC also raised concerns regarding the identification of the issuer of a derivative for purposes of the diversification classification because a derivative provides exposure both to the issuer of the derivative and to the issuer of the underlying reference security.

The SEC requests public comment on the application of the Investment Company Act's diversification requirements to derivatives held in fund portfolios, including:

- how a derivative should be valued for purposes of applying the diversification tests and whether different or additional diversification standards should be developed to address derivatives exposure;
- whether the mark-to-market value can provide an adequate measure of a fund's derivative exposure and whether such exposure may be understated under mark-to-market measurements;
- whether derivative investment counterparties should be considered "issuers" of securities for the purposes of the diversification requirements, and if so, how counterparty obligations should be addressed (*e.g.*, the 2010 ABA Derivatives Report recommends that counterparty exposures should be disregarded for purposes of the diversification classification and addressed separately under Section 12(d)(3) of the Investment Company Act); and
- whether a derivative's reference asset should be considered a security issued by an issuer for purposes of the diversification requirements in lieu of, or in addition to, the derivative counterparty.

Concentration. Under the Investment Company Act, a fund is required to disclose in its registration statement its policy concerning investment concentration in a particular industry or group of industries. According to the SEC, a fund is considered to be concentrated in a particular industry or group of industries if the fund invests more than 25% of its net assets in a particular industry or group of industries. When a fund enters into a derivatives transaction, the fund may gain exposure to more than simply the reference asset. For example, in the case of a total return swap entered into between a fund and a bank on stock issued by an automobile manufacturer, the fund may become exposed to both the banking and automobile industries.

The SEC requests public comment on how funds apply the concentration requirements to their investments in derivatives, including whether:

- funds currently value derivatives using the notional amount, market value or some other measure in determining industry concentration;
- funds currently take into account exposures to the industry or industries (if any) of the reference assets underlying such derivatives, in addition to the industry or industries of which their derivative counterparties are a part, and whether focusing only on the former would be consistent with the policies and purposes underlying the concentration requirements; and
- the SEC should provide guidance on industry concentration requirements to funds that use derivatives and, if so, what such guidance should entail.

Application of the Investment Company Act's provisions governing valuation of fund assets

As part of calculating its net asset value ("**NAV**"), a fund must determine the value of any derivatives it holds. According to the SEC, under the Investment Company Act, most funds must calculate their NAVs by using the market values of their portfolio securities when market quotations for those securities are readily available, or fair value, as determined in good faith by the fund's board of directors, if market quotations are not readily available. The SEC expressed concern that determining the fair value of certain derivatives may present special challenges.

The SEC requests public comment on the valuation of derivatives by funds, including:

- the methods funds currently use to determine the fair value of derivatives and assess the accuracy and reliability of pricing information obtained from counterparties or other sources;
- how funds currently take into account contractual restrictions on transferability and restrictions on the ability of a fund to close out the contract or enter into an offsetting transaction;
- how funds account for changes in the value of reference assets underlying derivatives, and whether funds calculate such values in the same manner for derivatives that have negative values as those that have positive values; and
- whether the SEC should issue guidance on the fair valuation of derivatives and, if so, what such guidance should entail.

Comments on the Derivatives Concept Release are due by November 7, 2011.

- ► See a copy of the Derivatives Concept Release:
- ► See a copy of the SEC's press release regarding the Derivatives Concept Release

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SEC Seeks Public Comment on Mortgage-Related Pools under the Investment Company Act

On August 31, 2011, the SEC issued a concept release (the "**Mortgage Concept Release**") reviewing interpretive issues relating to the Investment Company Act of 1940 (the "**Investment Company Act**") status of companies engaged in the business of acquiring mortgages and mortgage-related instruments ("**mortgage-related pools**"), including real-estate investment trusts, many of which seek to rely on the exclusion under Section 3(c)(5)(C) of the Investment Company Act ("**Section 3(c)(5)(C)**") from the definition of an "investment company." Noting the evolution and expansion of mortgage markets since Section 3(c)(5)(C)'s enactment in 1940, and the reliance upon Section 3(c)(5)(C) by a wide variety of mortgage-related pools, the Mortgage Concept Release seeks public comment on interpretative issues relating to the status of mortgage-related pools under the Investment Company Act and whether sufficient SEC guidance exists to assist mortgage-related pools in making judgments about their status under the Investment Company Act. A summary of the major issues for which the SEC requests public comment is set forth below:

Companies that Rely on Section 3(c)(5)(C). Section 3(c)(5)(C) excludes from the definition of investment company "[a]ny person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged . . . [in the business of] purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." The SEC requests information about mortgage-related pools that rely on Section 3(c)(5)(C), including with respect to:

- corporate governance and management styles, the types of investors that invest in such pools, and the roles of such companies in the mortgage markets;

- any differences between companies that originate mortgages and continue to hold all or portions of those mortgages and companies that only invest in mortgages and mortgage-related instruments;
- information about both public (exchange-traded and non-exchange traded) and privately offered mortgage-related pools and similar companies; and
- the similarities and operational or structural differences between certain mortgage-related pools and traditional investment companies, the presence of potential concerns under the Investment Company Act, such as self-dealing, misvaluation of assets and extensive leverage, and the existing safeguards in the structure and operations of mortgage-related pools that may address such concerns.

Exclusion Provided By Section 3(c)(5)(C). According to the Mortgage Concept Release, in interpreting the Section 3(c)(5)(C) exclusion and whether a person is primarily engaged in "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate," the SEC staff has focused on whether at least 55% of the issuer's assets will consist of mortgages and other liens on and interests in real estate ("**qualifying interests**") and the remaining 45% will consist primarily of real estate-type interests. The SEC noted that despite existing staff guidance, differences and uncertainties exist among mortgage-related pools regarding what assets constitute a qualifying interest or real estate-type interest. The SEC expressed concerned that some mortgage-related pools currently relying on Section 3(c)(5)(C) may closely resemble investment companies that are closed-end funds and may not be the types of companies intended to be excluded from regulation under the Investment Company Act. The SEC requests public comment regarding current interpretations of Section 3(c)(5)(C), including:

- any difficulties mortgage-related pools have encountered in determining their Investment Company Act status, including uncertainty or differing views among pools regarding the availability of the exclusion and whether certain pools may be giving too broad an interpretation to this exclusion resulting in companies that resemble traditional investment companies avoiding regulation under the Investment Company Act;
- the appropriateness of the SEC's 55/45 rule and whether the SEC should continue to treat "whole pool certificates" issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae as interests in real estate; and
- whether SEC guidance is needed regarding other types of mortgage-related instruments (*e.g.*, with respect to the appropriate treatment of certificates issued by pools holding whole loans and participation interests in loans that are secured by commercial real estate).

The SEC also solicits public comment on whether a test could be designed to distinguish companies primarily engaged in the real estate and mortgage banking business from traditional investment companies. For example, the SEC queries whether it should define "liens on and interests in real estate" in Section 3(c)(5)(C) to include only those assets that are directly related to real estate, and whether it should also consider other potential differentiating factors, such as the company's income, historical development or business activities.

Comments on the Mortgage Concept Release are due by November 7, 2011.

- See a copy of the Mortgage Concept Release:
- See a copy of the SEC's press release regarding the Mortgage Concept Release

SEC Proposes Rule Regarding Treatment of Asset-Backed Issuers under the Investment Company Act of 1940

On August 31, 2011, the SEC issued an Advance Notice of Proposed Rulemaking (the "**Proposed Rule**") on possible amendments to Rule 3a-7 ("**Rule 3a-7**") under the Investment Company Act of 1940 (the "**Investment Company Act**"), which provides certain asset-backed issuers ("**Issuers**") with a conditional exclusion from the definition of "investment company" under the Investment Company Act. The Proposed Rule solicits public comment on such possible amendments, including: (i) replacing, in light of the Dodd-Frank Act's mandate to review the use of credit ratings in SEC regulations, existing credit ratings conditions in Rule 3a-7 with new conditions to address the structure and operations of Issuers (including a requirement that an Issuer undergo an independent review to protect investors against self-dealing and overreaching by insiders); and (ii) strengthening the provisions of Rule 3a-7 relating to the preservation and safekeeping of eligible assets and cash flow of an Issuer (such as requiring a servicer to keep the cash flow of Issuers in a segregated account). Among other things, the Proposed Rule solicits comment on whether Rule 3a-7 Issuers should be considered "investment companies" under the Investment Company Act for the limited purpose of determining whether an entity investing in Rule 3a-7 Issuers itself meets the definition of "investment company" under the Investment Company Act. The Proposed Rule also requests comment on whether Section 3(c)(5) of the Investment Company Act should be amended to limit the ability of Issuers, including certain issuers of mortgage-backed securities, to rely upon that section for an exclusion from the definition of "investment company" under the Investment Company Act. A description of some of the key issues for which the SEC requests public comment is set forth below. The SEC is also withdrawing its 2008 proposal to amend Rule 3a-7 (discussed in the ***August 4, 2008 Investment Management Regulatory Update***).

Rating Requirements. Rule 3a-7 excludes from the definition of "investment company" certain Issuers that meet the rule's conditions. The rule includes several conditions that refer to credit ratings by nationally recognized statistical rating organizations ("**rating agencies**"). For example, an Issuer relying on Rule 3a-7 generally must have its publicly-issued fixed-income securities rated by at least one rating agency in one of the four highest ratings categories. Any acquisition or disposition of eligible assets by the Issuer must not result in a downgrading of the Issuer's fixed income securities. Additionally, cash flow from an Issuer's eligible assets must generally be deposited into a segregated account maintained or controlled by an independent trustee "consistent with the rating of the outstanding fixed-income securities." In light of the Dodd-Frank Act's mandate to review the use of credit ratings in SEC regulations, the SEC is considering eliminating references to credit ratings in Rule 3a-7, and solicits public comment on certain questions including:

- the analysis that rating agencies typically conduct in providing ratings, whether ratings serve as an adequate proxy for addressing investment company regulation concerns and whether it continues to be appropriate to rely on such ratings with respect to Rule 3a-7;
- whether some or all of the references to ratings should be removed from Rule 3a-7;
- possible replacement standards that could similarly address the investor protection considerations of the Investment Company Act; and
- the extent to which Issuers have relied on an exception in Rule 3a-7 that permits Issuers to offer fixed-income securities to sophisticated investors without such securities being rated by a rating agency and whether such securities were publicly or privately offered.

Possible New Conditions for Rule 3a-7. The SEC is soliciting public comment on whether certain new conditions should be added to Rule 3a-7 to address investor protection concerns under the Investment Company Act, including regarding the following:

Structural and Operational Integrity of the Issuer. The SEC requests public comment on adding structural and operational safeguards to Rule 3a-7 to address the potential for abusive practices by an Issuer, such as self-dealing, misvaluation of assets and inadequate asset coverage. The SEC notes that it could impose specific requirements or limitations on the structure and operations of an Issuer relying on Rule 3a-7 (*e.g.*, by specifying the selection and valuation of assets and structuring of the Issuer and prohibiting any person involved in the Issuer's operations from engaging in specific activities that may adversely affect the terms of payment for the fixed-income securities) or alternatively take a less prescriptive, principles-based approach (*e.g.*, requiring the parameters of the Issuer's organization and operations to be set forth in its organizational documents). Accordingly, the SEC requests public comment regarding:

- which of these approaches is more consistent with investor protection; the potential economic impact, costs and benefits of such approaches;
- whether there are other approaches that the SEC should consider; and
- whether there are other investor protection concerns that should be addressed in addition to self-dealing, misvaluation of assets and inadequate asset coverage.

Benefits of Independent Review of an Issuer's Structure and Intended Operations. The SEC requests public comment on whether to replace the rating condition currently contained in Rule 3a-7, in part, with a condition requiring an independent review of the Issuer and its intended operations prior to the issuance of fixed-income securities. For example, the SEC states that the rule could require an opinion from a third-party evaluator (or a similar certification from the Issuer itself, based on the consideration of the views of a third-party evaluator) as to the reasonable belief, based on information available at the time of review, that the Issuer is structured and would be operated in a manner such that the expected cash flow generated from the underlying assets would likely permit the Issuer to service its expected payment obligations. In connection with these potential changes, the SEC is soliciting public comment regarding:

- whether such independent review would serve to address concerns arising under the Investment Company Act regarding self-dealing and overreaching by insiders, and what the scope of such review should be;
- what types of qualification and independence requirements should be imposed on third-party evaluators (and whether rating agencies should be allowed to serve as third-party evaluators), the steps the Issuer should be required to take to determine eligibility of a third-party evaluator and the potential expert liability for the third-party evaluator under the registration statement;
- the economic impact of such a review requirement; and
- potential exemptions from such a review requirement, including for securities offered and sold solely to investors that meet certain objective standards, such as "qualified institutional buyers" within the meaning of Rule 144A under the Securities Act of 1933.

Preservation and Safekeeping of an Issuer's Eligible Assets and Cash Flow. The SEC requests public comment regarding whether Rule 3a-7 should be amended to strengthen the provisions relating to the preservation and safekeeping of eligible assets and cash flow of an Issuer. For example, the SEC notes that Rule 3a-7 currently does not restrict the practice of servicers who commingle the cash flow of Issuers with their own assets prior to transferring such cash flow to the independent trustee, and questions whether such practice "may be unnecessarily putting the cash flow at risk." The SEC also states that Rule 3a-7 also does not address cash flow treatment in cases where there is a timing mismatch between the receipt of collections from eligible assets and the distributions to the fixed-income securities holders. Additionally, the SEC queries whether Rule 3a-7's current requirement that an issuer take reasonable steps to cause an independent trustee to have a perfected security interest or ownership valid against third parties in the eligible assets should be further strengthened in light of recent irregularities (*e.g.*, poor recordkeeping in foreclosure proceedings) that have caused difficulties in determining the ownership of certain securitized mortgages.

Related to these issues, the SEC solicits public comment regarding:

- whether current safeguarding requirements under Rule 3a-7 are sufficient to safeguard eligible assets, or whether stronger safeguards should be adopted;
- whether a servicer should be required to keep the cash flow of Issuers in a segregated account or transfer such cash flow to the independent trustee within a specified time period (and the resulting economic impact of such a requirement);
- whether Rule 3a-7 should contain restrictions on the manner in which the cash flow may be invested or limit who may receive the benefit of the returns of such investment;
- whether Rule 3a-7 should include a condition specifying that the eligible assets and cash flow be available to pay the fixed-income securities in accordance with their terms, notwithstanding the bankruptcy or insolvency of the sponsor or depositor, and whether this should extend to the bankruptcy of the servicer; and
- any other concerns relating to the safekeeping of the issuer's assets and cash flow not otherwise contemplated in Rule 3a-7.

Other Possible Investor Protections. The SEC requests public comment on how existing or proposed provisions under other federal securities laws applicable to Issuers may help to address Investment Company Act concerns, and the extent to which such provisions could be considered for inclusion in Rule 3a-7 as a substitute for the rating condition.

Eligibility to Use Rule 3a-7. The SEC also requests public comment on a variety of issues regarding issuer eligibility to rely on Rule 3a-7, including with respect to asset-backed commercial paper programs.

Standard for Acquisition and Disposition of Eligible Assets. The SEC states that Rule 3a-7 was intended to permit only those activities that do not resemble the typical management of registered investment company portfolios. The SEC requests public comment to determine whether the current provisions in Rule 3a-7 sufficiently preclude such activities by Issuers, and whether any changes should be made to Rule 3a-7 to address the acquisition and disposition of eligible assets.

Effect of the Exclusion Provided by Rule 3a-7. The SEC solicits public comment on whether Rule 3a-7 issuers should be considered "investment companies" under the Investment Company Act for the limited purposes of (i) determining whether an entity investing in Rule 3a-7 Issuers itself meets the definition of "investment company" under the Investment Company Act and (ii) the definition of "eligible portfolio company" under the Investment Company Act, which may impact the ability of business development companies to invest in the securities of Rule 3a-7 Issuers.

Issuers Relying on Section 3(c)(5). The SEC requests public comment on whether Section 3(c)(5) of the Investment Company Act should be amended to limit the ability of Issuers, including certain issuers of mortgage-backed securities, to rely upon that section for an exclusion from the definition of "investment company" under the Investment Company Act. Please see above for a discussion of the companion concept release reviewing interpretive issues generally under Section 3(c)(5) of the Investment Company Act.

Comments on the Proposed Rule are due by November 7, 2011.

- See a copy of the Proposed Rule:
- See a copy of the SEC's press release regarding the Proposed Rule

Industry Update

Treasury Issues FAQ Regarding Proposed Form SLT; Initial Reports Due by October 24, 2011

On August 4, 2011, the U.S. Department of the Treasury ("**Treasury**") issued responses to a number of frequently asked questions ("**FAQs**") regarding Form SLT. Form SLT was issued by Treasury in connection with its Treasury International Capital reporting system, which tracks international capital movements. U.S. investment managers are required to file Form SLT in their capacity as (i) U.S. resident issuers of U.S. long-term securities, (ii) U.S. resident end-investors in foreign long-term securities or (iii) U.S. custodians in the limited circumstances described below, if the U.S. investment manager's consolidated total of all reportable securities exceeds the reporting threshold of $1 billion. The initial reporting date for Form SLT is September 30, 2011 and initial reports are due by October 24, 2011. For more information regarding Treasury's Form SLT, please see the ***April 15, 2011 Investment Management Regulatory Update*** and the ***June 10, 2011 Investment Management Regulatory Update***. The FAQs clarify, among other things:

Consolidation Rules. The FAQs clarify the consolidation rules for reporting. The FAQs state that a U.S. investment manager/fund sponsor ("**IM/FS**") should report consolidated data for all U.S.-resident clients and funds that it manages/sponsors, including separately managed accounts and stand-alone funds.

Reporting Requirements for Master-Feeder Fund Structures. With respect to master-feeder fund structures, the FAQs state that an IM/FS should report:

- As an issuer on Part B of the TIC SLT Form.
  - U.S. master fund equity interests owned by foreign feeder funds that are not held through unaffiliated U.S.-resident custodians in accounts in the names of such foreign feeder funds.
- As an end-investor on Part B of the TIC SLT Form.
  - Foreign long-term securities owned by U.S. master funds that are not held in custody by U.S.-resident custodians in accounts in the names of such U.S. master funds.
  - Foreign master fund equity interests owned by U.S. feeder funds that are not held through unaffiliated U.S.-resident custodians in accounts in the names of such U.S. feeder funds.
- As a custodian on Part A of the TIC SLT Form.
  - U.S. long-term securities owned by foreign master funds, if those securities are not held by a U.S.-resident custodian in an account in the name of the foreign feeder fund, but are held in an omnibus customer account in the name of the IM/FS.

Securities Reportable by Custodians. The FAQs offer guidance on who has reporting responsibility on Form SLT under various scenarios and notes that U.S. custodians, not investment managers, are responsible for reporting in the following cases:

- Foreign long-term securities owned by a U.S.-resident end-investor that are entrusted to an unaffiliated U.S.-resident custodian that knows the identity of the end-investor;
- U.S. long-term securities owned by a foreign-resident end-investor that are entrusted to a U.S. custodian that knows the identity of the end-investor.

Exemption Level and Reporting Frequency. The FAQs clarify certain questions regarding calculation of the $1 billion reporting exemption level and reporting frequency. For example, the FAQs state that in determining whether it exceeds the $1 billion reporting threshold, a U.S. end-investor should aggregate all of its reportable foreign long-term securities, including directly held portfolio investments in funds and limited partnerships, that are not held by a U.S.-resident custodian in an account in the name of the end-investor. All reportable U.S. long-term securities issued by the end-investor directly to foreign investors should also be included in the calculation.

Accounting, Valuation and Currency Conversion Rules. The FAQs provide guidance on valuation and currency conversion for determining the value of long-term securities to be reported. For example, the FAQs clarify that the fair value reported on Form SLT should be calculated in accordance with U.S. GAAP, excluding the value of unfunded commitments to invest. The fair value of any investments owned by an investment vehicle should not be reduced by the amount of debt used to purchase such investments.

In addition to the FAQs, Treasury has published FAQ guidance and flowcharts detailing the reporting responsibilities for persons required to complete and submit Form SLT.

- See a copy of the TIC Form SLT and instructions:
- See a copy of the Frequently Asked Questions:
- See a copy of the Reporting Responsibilities Flowcharts:

Massachusetts Adopts Regulations on Use of Expert Network Firms

On August 8, 2011, the Massachusetts Securities Division (the "**Division**") adopted new regulations addressing the use of expert-network firms by investment advisers. (In a press release issued in connection with the proposed expert-network regulations, the Secretary of the Commonwealth of Massachusetts, William F. Galvin, indicated that the regulations would apply to state-registered investment advisers.) Generally speaking, expert-network firms connect consultants, including current and former employees of publicly traded companies, with investment advisers in order to provide information about companies. Adopting the regulations substantially as proposed, the Division stated that the regulations seek to provide investment advisers with greater clarity as to what is impermissible conduct when paying consultants for information. For more information on the proposed regulations, please see the ***May 17, 2011 Investment Management Regulatory Update.***

Under the new regulations, effective December 1, 2011, a covered investment adviser that retains a consultant for compensated "Investment Consulting Services" must obtain written certification from such consultant that: (i) describes all confidentiality restrictions relevant to the potential consultation that the consultant has or reasonably expects to have; (ii) affirmatively states the consultant will not provide any confidential information to the investment adviser and (iii) is signed and dated by the consultant, and is accurate as of the date of the initial, and any subsequent, consultation(s). "Investment Consulting Services" is defined as a consultation for the purposes of assisting the investment adviser's decisions as to whether to engage in securities transactions for client accounts. Notwithstanding such certification requirements, an investment adviser who comes into possession of material non-public information through a consultation is prohibited under the new regulations from trading on such information until it is no longer material non-public information.

- See a copy of the adopting release:
- See a copy of the text of the amendments adopted and approved by the Secretary of the Commonwealth of Massachusetts:

Litigation

Second Circuit Issues Decision Regarding Group Formation for Section 13(d) Beneficial Ownership Reporting Purposes

On July 18, 2011, the U.S. Court of Appeals for the Second Circuit (the "**Second Circuit**") issued a decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*, 08-2899-cv (L), 08-3016-cv (XAP), 2011 WL 2750913 (C.A.2 (N.Y.)) (2d Cir. July 18, 2011), regarding certain beneficial ownership reporting issues under Section 13(d) ("**Section 13(d)**") of the Securities and Exchange Act of 1934 (the "**Exchange Act**"). Although the Second Circuit declined to rule on whether and under what circumstances a long party to a cash-settled, total return equity swap may be deemed, for purposes of Section 13(d), the beneficial owner of the reference shares purchased by the short counterparty as a hedge, it did provide guidance on what constitutes a "group" for beneficial ownership reporting purposes under Section 13(d). Under Section 13(d) of the Exchange Act, any person or group that acquires more than a 5% beneficial ownership of a class of voting equity securities registered under Section 12 of the Exchange Act is required to file a Schedule 13D with the SEC disclosing its ownership and certain other information. Rule 13d-5(b)(1) under the Exchange Act provides that Section 13(d) reporting requirements apply to aggregate holdings of any "group" formed "for the purpose of acquiring, holding, voting or disposing" of an issuer's equity securities.

According to the Second Circuit decision, two hedge funds, The Children's Investment Fund Management ("**TCI**") and 3G Capital Partners ("**3G**" and, together with TCI, the "**Funds**"), waged a proxy contest seeking to elect a minority slate of candidates to CSX Corporation's ("**CSX's**") board of directors. Both Funds owned voting shares of CSX in addition to being the long parties to cash-settled, total return equity swaps of CSX shares, with several financial institutions acting as short counterparties. CSX brought an action against the Funds on March 17, 2008 seeking to enjoin the Funds from voting their shares (which represented a combined 6.4% stake) in the proxy contest. The United States District Court for the Southern District of New York (the "**District Court**") held that TCI's investments in cash-settled, total return equity swaps referencing CSX shares conferred beneficial ownership of such shares to TCI, which TCI failed timely to disclose. The District Court stated that although TCI did not have any legal rights with respect to the voting or disposition of the CSX shares held by the short counterparties, TCI used the total return swaps as "part of a plan or scheme to evade the reporting requirements of Section 13(d)," thus triggering Rule 13d-3(b) under the Exchange Act, which deems any person using such a plan or scheme a beneficial owner of the relevant security. The District Court also found that the Funds failed timely to file a Schedule 13D after forming a "group" for purposes of Section 13(d), noting the pre-existing relationship between the Funds, the exchange of views and information regarding CSX and the parallel pattern of share purchases and proxy fight preparations, which the District Court determined to indicate a strategic plan to act as a group as early as February 2007 while the Funds ultimately filed a Schedule 13D only in December 2007. The District Court granted a permanent injunction against further violations of Section 13(d) by the Funds, but declined to enjoin the Funds from voting their CSX shares in the proxy contest, noting that the Funds ultimately did file a Schedule 13D disclosing ownership of the CSX shares prior to the vote.

Citing divided views within the panel, the Second Circuit declined to rule on whether and under what circumstances a long party to a cash-settled, total return equity swap may be deemed, for purposes of Section 13(d), the beneficial owner of the reference shares purchased by the short counterparty as a hedge. However, the Second Circuit remanded the case to the District Court to re-examine whether a "group" was formed between TCI and 3G for purposes of Section 13(d). The Second Circuit stated that although the District Court had found the existence of a group "with respect to CSX securities," it had failed to find that a group was specifically formed for the purpose of "acquiring, holding, voting or disposing" of CSX securities consistent with Rule 13d-5(b)(1) under the Exchange Act. The Second Circuit clarified that "even if many of the parties' 'activities' were the result of a group action, two or more entities do not become a group within the meaning of [Section 13(d)] unless they act as a group for the purpose of acquiring, [holding, voting or disposing] . . . securities of an issuer." The Second Circuit directed the District Court to consider the specific types of concerted action that result in group formation, in particular, instructing the District Court to make "a precise finding, adequately supported by specific evidence . . . " as to whether the Funds "formed a group for the purpose of 'acquiring, holding, voting or disposing'. . . CSX shares."

- See a copy of the Second Circuit opinion:

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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