

Investment Services Regulatory Update

April 5, 2010

LITIGATION

U.S. Supreme Court Rules in *Jones v. Harris Associates*; Vacates and Remands *Gallus v. Ameriprise Financial*

On March 30, 2010, the U.S. Supreme Court issued its decision in *Jones v. Harris Associates*, embracing the *Gartenberg* standard (from the Second Circuit) for evaluating advisory fees and rejecting the approach articulated by the Seventh Circuit, which looks to market efficiency and trust law fiduciary duty. In doing so, the Court resolved a circuit split and established the standard governing excessive fee claims arising under Section 36(b) of the 1940 Act. Furthermore, the Court provided clarity with respect to the scope of the fiduciary duty articulated in Section 36(b) of the 1940 Act. Additionally, on April 5, 2010, the Court vacated the decision in *Gallus v. Ameriprise Financial Inc.* and remanded the case to the U.S. Court of Appeals for the Eighth Circuit to be considered in light of *Jones*.

In an opinion authored by Justice Alito, the unanimous Court held in *Jones* that the Second Circuit, in *Gartenberg*, “was correct in its basic formulation: to face liability under Section 36(b), an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.” According to the Court, the *Gartenberg* approach “fully incorporates” the meaning of the phrase fiduciary duty as previously set forth by the Court: “the essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain.” In contrast to trust law fiduciary duty, the fiduciary duty set forth in Section 36(b) shifts the burden of proof from the fiduciary to the party claiming the breach. Thus, a successful claim arising under Section 36(b) requires a showing by the party claiming the violation that the fee charged by an investment adviser was outside of the range that arm’s-length bargaining would produce.

With respect to a court’s role in evaluating excessive fee claims arising under Section 36(b), the Court noted that “the standard for fiduciary breach under [Section] 36(b) does not call for judicial second-guessing of informed board decisions.” Furthermore, a court should not “supplant the judgment of disinterested directors apprised of all relevant information, without additional evidence that the fee exceeds the arm’s-length range.” However, the Court also noted that, where a board’s process is deficient or where the adviser withheld important information, “the court must take a more rigorous look at the outcome.” In cases of an adviser failing to disclose material information, “greater scrutiny is justified because the withheld information might have hampered the board’s ability to function as ‘an independent check upon management.’” According to the Court, “a court’s evaluation of an investment adviser’s fiduciary duty must take into account both procedure and substance.”

On the issue of whether courts may consider differences in rates that investment advisers charge institutional clients and funds in the context of Section 36(b) claims, the Court stated that, “[s]ince the [1940 Act] requires consideration of all relevant factors . . . there [cannot] be any categorical rule regarding the comparisons of the fees charged different types of clients Instead, courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require” However, the Court went on to add that courts “must be wary of inapt comparisons,” as “there may be significant differences between the services provided by an investment adviser to a mutual fund and those it provides to a pension fund which are attributable to the greater frequency of shareholder redemptions in a mutual fund, the higher turnover of mutual fund assets, the more burdensome regulatory and legal obligations, and higher marketing costs.” The Court instructed that, “[i]f the services rendered are sufficiently different that a comparison is not probative, then courts must reject such a comparison. Even if the services provided and fees charged to an independent fund are relevant, courts should be mindful that the [1940] Act does not necessarily ensure fee parity between mutual funds and institutional clients. . . .” The Court further noted with respect to fee comparisons that “courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers . . . [as they] may not be the product of negotiations conducted at arm’s length.”

In a concurring opinion, Justice Thomas cautioned that the majority opinion should not be described “as an affirmation” of the *Gartenberg* standard, as it “does not countenance the free-ranging judicial ‘fairness’ review of fees that *Gartenberg* could be read to authorize and that virtually all courts deciding Section 36(b) cases since *Gartenberg* . . . have wisely eschewed in the post *Gartenberg* precedents we approve.” According to Justice Thomas, the Court’s opinion rightly emphasizes the statutory restraints on a court’s review of excessive fee claims arising under Section 36(b) and “follows an approach that defers to the informed conclusions of disinterested boards and holds plaintiffs to their heavy burden of proof in the manner the [1940] Act requires.”

Court Allows Class Action Against Evergreen Entities and Fund Trustees to Proceed

In connection with a class action lawsuit by shareholders of the Evergreen Ultra Short Opportunities Fund against the fund, the adviser, the adviser’s parent, the distributor and officers and trustees of the fund, on March 31, 2010, the U.S. District Court for the District of Massachusetts generally denied the defendants’ motions to dismiss the 1933 Act claims that had been filed against them. (The court did dismiss one of the claims against the fund’s trustees.) The claims are based on the plaintiffs’ allegations that the fund’s prospectus omitted key facts and contained “materially false and misleading statements” about the fund’s investment objective and features. The plaintiffs also claim that the fund was marketed as a higher-yielding alternative to money market funds when in fact it invested in “increasingly illiquid” and “riskier-than-represented” mortgage-backed securities. In addition, the plaintiffs allege the value of the fund’s shares was overstated, resulting in investors buying and redeeming their fund shares at inaccurate

prices. As a result of such misrepresentations, the plaintiffs claim they lost approximately 25% of their investment in the fund.

District Court Judge Rules in Favor of Plaintiffs in Schwab YieldPlus Fund Case

On March 30, 2010, a district court judge in the Northern District of California granted the shareholder plaintiffs' motion for summary judgment in a case involving the concentration policy of the Schwab YieldPlus Fund. The fund had a fundamental policy not to concentrate (i.e., invest more than 25% of its assets) in any industry. In 2001, the fund began classifying non-agency mortgage-backed securities ("MBS") as a separate industry for concentration purposes and disclosed this in its SAI as a non-fundamental policy. Subsequently, in 2006, the fund identified non-agency MBS as not being part of any industry for purposes of its concentration policy and disclosed this fact in its SAI. The plaintiffs alleged that, by the end of February 2008, the fund had slightly more than 50% of its assets in MBS. The judge ruled that the fund violated the 1940 Act in not submitting these changes in industry classification to shareholders for approval. According to court documents, a settlement conference is scheduled for April 15, 2010.

The ICI filed an amicus brief endorsing the fund's defense and argued that fund boards have discretion to change non-fundamental industry classification policies without shareholder approval. The SEC, on the other hand, filed an amicus brief supporting the plaintiffs' position and argued that the fund's concentration policy and industry classification policy were part of the same fundamental policy, which the board could not change without shareholder approval.

First Circuit Rejects the SEC's Interpretation of Rule 10b-5

On March 10, 2010, the First Circuit, in its en banc ruling in *SEC v. Tambone*, rejected the SEC's expansive interpretation of Rule 10b-5(b), vacating part of a prior ruling by a three-judge panel. The ruling related to actions stemming from a 2005 settlement that the SEC reached with Columbia Management Advisors, Columbia Funds Distributors and three former employees relating to alleged undisclosed market timing arrangements in the Columbia funds. As principal underwriter and distributor of the Columbia funds, Columbia Funds Distributors sold shares in the funds and disseminated fund prospectuses to investors. Columbia Management Advisors drafted the prospectuses, which included representations that the funds prohibited market timing. On May 19, 2006, the SEC filed a civil complaint in the District of Massachusetts against James Tambone and Robert Hussey, who were officers of Columbia Funds Distributors. The defendants were not alleged to have spoken or written direct misstatements. Rather, the SEC brought suit based on the "implied representation" theory, alleging that, despite the defendants' awareness of the market timing prohibitions contained in the prospectuses, the defendants distributed the prospectuses while allowing certain preferred customers to engage in market timing in the Columbia funds.

In its complaint, the SEC alleged that the defendants violated Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act and Rule 10b-5 thereunder. In addition, the SEC



alleged that the defendants had aided and abetted primary violations of Section 10(b) and Rule 10b-5 by the adviser and the distributor, primary violations of Section 15(c) of the 1934 Act by the distributor and primary violations of Section 206 of the Advisers Act by the adviser. The defendants moved to dismiss the complaint, and in 2006, the district court dismissed all of the SEC's claims holding that the SEC did not allege that the defendants made untrue statements or material omissions to investors and therefore did not plead fraud with particularity.

The SEC appealed the dismissal of its Rule 10b-5(b), Section 17(a)(2) and aiding and abetting claims. In late 2008, a divided panel of the First Circuit reversed and reinstated all of the SEC's primary and aiding and abetting claims. After the First Circuit's initial opinion, upon petition by the defendants, the court ordered the case to be reheard en banc to determine whether primary liability under Rule 10b-5(b) could extend to defendants under the theories advanced by the SEC. In the en banc rehearing, a four-judge majority rejected the panel's reasoning and affirmed the district court's decision to dismiss the SEC's primary violator claims under Section 10(b) and Rule 10b-5(b). The court held that the SEC's interpretation is inconsistent with the text and structure of the rule and U.S. Supreme Court precedent.

In rejecting the SEC's interpretation of Rule 10b-5(b), the court examined what it means to "make a statement" under Rule 10b-5(b). Based on the ordinary meaning of the word "make" and the absence of evidence that the drafters intended to attach any "exotic meaning" to the word, the court concluded that the SEC's proposed reading was inconsistent with the text of both the statute and the rule. The court further supported its conclusion with a contextual analysis of other statutory provisions of the federal securities laws, highlighting that the drafters specifically and deliberately used the narrower verb "make" in Rule 10b-5(b) in comparison to other provisions of the federal securities laws.

Finally, in reaching its decision, the court analyzed Supreme Court precedent and stated that "[u]nder modern Supreme Court precedent dealing with Rule 10b-5, much turns on the distinction between primary and secondary violators. . . . If . . . the private right of action is not to be hollowed—and we do not think that it should be—courts must be vigilant to ensure that secondary violations are not shoehorned into the category reserved for primary violations."

Second Circuit Vacates Dismissal of Section 10(b) Claims Against Citigroup Entities, Affirms Dismissal of Section 36(b) Claims

On February 16, 2010, the Second Circuit Court of Appeals issued its ruling in *Operating Local 649 v. Smith Barney Fund Management LLC*. The case arose following a 2005 SEC investigation of Smith Barney Fund Management LLC and Citigroup Global Markets, Inc., both subsidiaries of Citigroup Asset Management (collectively "CAM"), related to alleged violations by CAM of the Investment Advisers Act for inducing the funds in the Smith Barney Family of Funds (the "Funds") to enter into a transfer agency contract with an affiliate of CAM that resulted in unnecessarily high expenses to the

Funds and undisclosed profits to CAM. Without admitting or denying the findings of the SEC investigation, CAM agreed with the SEC to pay more than \$200 million in fines and disgorged profits generated by the alleged scheme. Based on the findings of the SEC investigation, various Fund investors filed civil suits in the Southern District of New York seeking damages from CAM for violations of Section 10(b) and Rule 10b-5 of the Securities Exchange Act and Section 36(b) of the Investment Company Act. These suits were consolidated with Operating Local 649 serving as the lead plaintiff. Upon motion by CAM, the district court dismissed the suit holding that: (i) the mischaracterization of the fees paid to the affiliated transfer agent as transfer agent fees was not a false material misrepresentation under Section 10(b); and (ii) the Section 36(b) claim could only be brought derivatively on behalf of the Funds and not directly by the plaintiffs. The plaintiffs appealed the judgments of the district court and the Second Circuit vacated the dismissal of the Section 10(b) claims and affirmed the dismissal of the Section 36(b) claim.

With respect to the Section 10(b) claims, on appeal, the plaintiffs argued that the judgment of the district court should be reversed because CAM materially misrepresented the services performed by the affiliated transfer agent by not disclosing that: (i) the affiliated transfer agent would only operate a small call center; (ii) the affiliated transfer agent would subcontract the majority of transfer agent services to an unaffiliated party; and (iii) the unaffiliated party would charge substantially less for transfer agent fees than what the Funds would pay to the affiliated transfer agent. In addition, the plaintiffs contended that CAM, in the Funds' prospectuses, miscategorized the transfer agent fees that the affiliated transfer agent received as "other expenses" when they should have been categorized as "management fees." The Second Circuit agreed with the plaintiffs that CAM's misrepresentations were material. The Second Circuit reasoned that this conclusion was supported by (i) the SEC's prospectus and proxy disclosure rules which focus on the importance of fee disclosure to investors and the proper categorization of fees and (ii) the fiduciary duty with respect to management fees imposed by Section 36(b). The Second Circuit stated, "[f]ew facts would likely constitute more important ingredients in investors' 'total mix' of information than the fact that, in violation of [SEC] disclosure requirements the expenses categorized as transfer agent fees were not transfer agent fees at all and included kickbacks to [the affiliated transfer agent] and ultimately, CAM." The Second Circuit further stated, "[i]n light of the importance the SEC attaches to the proper categorization of fees generally, and the importance Congress has attached to management fees in particular, we hold that [CAM's] misrepresentations were material because there exists a substantial likelihood that a reasonable investor would consider it important that her fiduciary was, in essence, receiving kickbacks." In ruling for the plaintiffs, the Second Circuit also noted that the adviser "owed a duty of 'uncompromising fidelity' and 'undivided loyalty' to the Funds' shareholders." As such, CAM's fiduciary obligations required it to disclose candidly to the Funds' board and shareholders the "material features" of the transfer agency arrangement that it created.

With respect to the Section 36(b) claim, on appeal, the plaintiffs argued that the judgment of the district court should be reversed because in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984), the U.S. Supreme Court held that Federal Rule of Civil Procedure 23.1, which covers “derivative” actions, does not apply to Section 36(b) claims, and, therefore, if a Section 36(b) claim is not “derivative” within the meaning of Rule 23.1, then it can be brought as a direct claim by shareholders. The Second Circuit disagreed, stating that the plaintiffs’ reading of *Daily Income Fund* was too narrow. The Court went on to examine the history of *Daily Income Fund* noting that the end result of *Daily Income Fund* is that 36(b) claims are brought directly by shareholders to recover damages derivatively for a fund. The Second Circuit stated, “[t]o the extent [the plaintiff] seeks damages that inure to its own benefit and not to the Funds’, that result is not permitted by Section 36(b).”

Court Rules State Market Timing Claims Precluded by SLUSA

On January 6, 2010, in *Kircher v. Putnam Funds Trust*, the Illinois Appellate Court reversed the circuit court and remanded the case for dismissal, holding that the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) precluded the plaintiffs’ class action lawsuit against defendants alleging state law claims that their investments were diluted by the defendants’ market timing activities that were brought to light in September 2003. The defendants had removed the lawsuits to federal court and argued that SLUSA precluded such lawsuits from being filed and therefore the district court should dismiss the action. After a long battle over appropriate jurisdiction at the federal level that eventually led to a U.S. Supreme Court decision in June 2006, the case was sent back to the state level. In arriving at its decision, the Illinois Appellate Court explained that SLUSA does not actually preempt any state law cause of action but simply denies plaintiffs the right to use the class action device to vindicate certain claims. Under the terms of SLUSA, an action will be dismissed if it is (1) a covered class action, (2) that is based on a state law, (3) alleging a misrepresentation or omission of material fact or use of any manipulative or deceptive device or contrivance, (4) in connection with the purchase or sale of a covered security. After over six years of back and forth in multiple courts, the Illinois Appellate Court held that the action was indeed precluded by SLUSA. Despite public statements by the plaintiffs that they intended to file a petition for leave to appeal to the Illinois Supreme Court, the plaintiffs did not do so and the time to do so has now expired.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Releases AML Guidance on Beneficial Ownership Information

On March 5, 2010, the SEC issued a policy statement to provide guidance that clarifies and consolidates existing regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships for anti-money laundering purposes. Specifically, the guidance states that financial institutions should establish and maintain customer due diligence procedures that are reasonably designed to identify and verify the identity of beneficial owners of an account, as appropriate, based

on the institution's evaluation of risk pertaining to an account. The guidance took effect on March 5, 2010.

SEC Adopts Restrictions to Short-Selling Practices

On February 24, 2010, the SEC adopted changes to the rules regarding short-selling under the 1934 Act, by imposing a restriction on the prices at which securities traded on a national securities exchange (other than options) may be sold short. In a short sale transaction, a seller borrows a stock and sells it, with the understanding that the loan will be repaid by the seller by buying the stock on the open market. Pursuant to the amendments to Regulation SHO, a trading center must implement written policies and procedures reasonably designed to prevent the execution or display of a short sale order for a particular security at a price that is less than or equal to the current national best bid, if the price of that security has decreased by 10% or more from the prior day's closing price. Once the "circuit breaker" is triggered, this price test will remain in effect for the remainder of the trading day and the following day. The amendments also facilitate the ability of long sellers of the affected security to sell their shares before short sellers may do so, and further short sales are permitted only when the price of the security is above the current national best bid.

The amendments will become effective on May 10, 2010, with a compliance date of November 10, 2010.

SEC Adopts Amendments to Rules Requiring Internet Availability of Proxy Materials

On February 22, 2010, the SEC adopted 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 amendments 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 amendments, the proxy rules identify certain topics required to be covered in the notice, including that the notice itself is not a form for voting, but do not specify the exact language to be used. In addition, to improve shareholder understanding of the notice, the notice can be accompanied with an explanation of the notice and access model.

The 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. The amended proxy rules 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.

Finally, the rule amendments permit funds to accompany their Notice of Internet Availability of Proxy Materials with a summary prospectus.

SEC Adopts Money Market Fund Reforms

On January 27, 2010, the SEC adopted amendments to certain rules under the 1940 Act that govern money market funds. The amendments seek to: (1) increase the resilience of money market funds to short-term market risks, (2) reduce the likelihood of money market funds “breaking the buck,” and (3) improve the ability of the SEC to oversee money market funds. The rule amendments:

- prohibit money market funds from buying “second tier securities” with a maturity in excess of 45 days (rather than 397 days),
- restrict investments in “second tier securities” to 3% of assets (rather than 5%),
- limit investments in “second tier securities” issued by a single issuer to ½ of 1% of a fund’s assets,
- impose a 60-day weighted average maturity limit,
- impose a new maturity test that would limit “weighted average life maturity” (the measurement of a money market fund’s portfolio maturity without regard to any interest reset dates) to 120 days,
- redefine “illiquid security” and limit holdings in illiquid securities to 5% of assets (rather than 10%),
- require money market funds to hold at all times highly liquid securities sufficient to meet reasonably foreseeable redemptions,
- require *taxable* money market funds to hold at least 10% of assets in cash, U.S. Treasury securities and securities that convert to cash within one business day,
- require all money market funds (including tax-exempt funds) to maintain weekly liquidity requirements of 30% of assets in cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less or securities that convert to cash within one week,
- require money market fund managers to stress test periodically a fund’s portfolio, including testing of a fund’s ability to maintain a stable net asset value per share based on certain “shocks,”



- limit money market funds to investing in repurchase agreements collateralized by cash or U.S. government securities in order to obtain special treatment under the diversification provisions of Rule 2a-7,
- require money market funds to evaluate the creditworthiness of a counterparty to a repurchase agreement, whether or not the repurchase agreement is collateralized fully,
- require money market funds to post their portfolio holdings as of each month end to their website and to maintain such information on the website for at least six months,
- require money market funds to file a monthly portfolio holdings report, including “shadow” NAVs, with the SEC on new Form N-MFP (this information would be available to the public 60 days later),
- require money market funds and their administrators to be able to process purchases and redemptions electronically at a price other than \$1.00,
- require money market funds to annually designate at least four nationally recognized statistical rating organizations (“NRSROs”) whose ratings the fund board considers reliable,
- eliminate the requirement that money market funds invest only in those asset-backed securities that have been rated by an NRSRO,
- expand Rule 17a-9 to allow an affiliate to purchase a portfolio security from a money market fund (1) if the security has defaulted (other than an immaterial default unrelated to the financial condition of the issuer) even though the security remained an eligible security or (2) for any reason if the security is purchased with cash at the greater of amortized cost value or market value and the affiliate promptly remits to the fund any profit it realizes from a later sale of the security,
- require a money market fund whose securities have been purchased by an affiliate in reliance on Rule 17a-9 to provide the SEC via e-mail with prompt notice of the purchase and the reasons for the purchase, and
- create new Rule 22c-3, which would permit money market funds to suspend redemptions if a fund is about to break the buck if the fund’s board, including a majority of independent directors, approves the liquidation of the fund in order to facilitate an orderly liquidation of the fund.

In the Adopting Release, the SEC stated that, in circumstances where a fund's existing disclosed policy is less restrictive than, and does not conflict with, the rule amendments (e.g., having a policy of maintaining a weighted average maturity no greater than 90 days, which is less restrictive than the new 60-day requirement), a fund need not hold a shareholder vote in order to comply with the amendments. In addition, a fund may amend its registration statement to reflect compliance with the amendments under Rule 485(b), as long as other changes in the amendment meet the conditions for immediate effectiveness.

The compliance date for the amendments related to portfolio quality, maturity, liquidity and repurchase agreements is May 28, 2010. Funds are not required to dispose of portfolio securities owned, or terminate repurchase agreements entered into, as of the time of adoption of the amendments to comply with the requirements of the amended rule. Funds must comply with the new maximum weighted average maturity and weighted average life maturity limits by June 30, 2010.

Each fund must disclose its designated NRSROs in its SAI no later than December 31, 2010. The compliance date for fund website disclosure of portfolio holdings is October 7, 2010, and funds must begin filing information on Form N-MFP with the SEC by December 7, 2010. Beginning on October 7, 2010, funds may submit this data to the SEC voluntarily on a trial basis for purposes of testing the SEC's filing system and receiving feedback from the SEC staff. The SEC does not intend to make these trial submissions public.

Funds must be able to process transactions at prices other than stable NAV by October 31, 2011. The compliance date for all other rule changes not specifically identified above is May 5, 2010.

FINRA Provides Guidance on Blogs and Social Networking Websites

On January 25, 2010, FINRA issued Regulatory Notice 10-06, which provides guidance to securities firms and brokers on communications with the public through blogs and social networking websites. The Notice follows previous rules issued by FINRA on Internet communications, including NASD Rule 2210, which defines the term "public appearance" to include participation in an interactive electronic forum. The Notice is presented in question and answer format and includes the following recommendations and conclusions:

- Every firm that intends to communicate through social media sites, or permit its associated persons to communicate through such sites, must comply with specified record retention requirements.
- Any communication via a social media site that constitutes a "recommendation" is also subject to suitability requirements for every investor to whom it is made.



- In addition to triggering FINRA's suitability rule, communications containing recommendations of specific investment products through social media sites may trigger disclosure requirements under the federal securities laws, such as Rule 482 under the 1933 Act and the filing requirements of Section 24(b) of the 1940 Act.
- Interactive electronic communications by the firm or its registered representatives must be supervised in a manner reasonably designed to ensure that FINRA's communications rules are not violated.
- Third-party content posted to social media sites established by the firm or its personnel will generally not be treated as communications with the public, unless such content becomes "attributable" to the firm under the "entanglement" or "adoption" theories outlined in the Notice.

LEGISLATION

Senate Committee Approves Restoring American Financial Stability Act of 2010

In March 2010, the Senate Banking, Housing and Urban Affairs Committee approved a revised version of the financial reform bill, Restoring American Financial Stability Act of 2010, released by Senator Christopher Dodd, Chairman of the Committee, earlier that month. Similar to a bill passed by the House of Representatives in 2009, among other provisions, the Act would:

- establish a Financial Services Oversight Council comprised primarily of the heads of various financial regulatory entities that would monitor, identify and address threats to the stability of the U.S. financial markets, and together with the Federal Reserve or other applicable federal regulator, impose stricter standards and safeguards on any financial company, activity or practice that poses a threat to the stability of the markets and require, as a last resort, certain financial companies that pose a grave threat to the stability of the markets to divest some of their holdings;
- require the Federal Reserve and other federal banking agencies, subject to the recommendations and modifications of the Financial Services Oversight Council, to prescribe rules (1) prohibiting proprietary trading and sponsoring or investing in hedge funds or private equity funds by insured depository institutions, companies controlling insured depository institutions or that are treated as bank holding companies and subsidiaries of such institutions and companies and (2) imposing additional capital requirements and quantitative limits for nonbank financial companies supervised by the Federal Reserve that engage in proprietary trading or sponsoring or investing in hedge funds and private equity funds;

- require investment advisers of certain unregistered investment companies (i.e., 3(c)(1) and 3(c)(7) funds), excluding “venture capital funds” and “private equity funds” as defined by the SEC, to register with and provide information to the SEC;
- authorize the self-funding of the SEC;
- authorize the SEC to prescribe rules and regulations requiring the inclusion of shareholder-proposed board nominees in issuer proxy solicitations;
- permit the SEC to issue rules requiring broker-dealers to provide documents or information to retail investors before they purchase investment products or services;
- permit the SEC to limit the use of pre-dispute arbitration provisions in broker-dealer agreements;
- subject auditors of broker-dealers to regulation by the Public Company Accounting Oversight Board;
- increase the asset threshold for federally-registered investment advisers to \$100,000,000;
- authorize an increase in the accredited investor financial threshold for natural persons; and
- require the SEC to conduct studies regarding (1) the effectiveness of, or gaps or overlaps in, legal and regulatory standards of care applicable to broker-dealers and other investment professionals providing services to retail investors (the SEC also would be authorized to prescribe rules and regulations to address any gaps or overlaps identified in the study), (2) the potential impact of eliminating the broker-dealer investment adviser registration exemption, (3) the financial literacy of retail investors and (4) mutual fund advertising.

Congressman Introduces Banking Integrity Act

On January 15, 2010, Representative John D. Dingell introduced the Banking Integrity Act of 2010, which would prohibit, with limited exceptions, any officer, director or employee of any corporation or unincorporated association, any partner or employee of a partnership, and any individual primarily engaged in the issue, flotation, underwriting, public sale or distribution of stocks, bonds or other similar securities from serving simultaneously as an officer, director or employee of any member bank. The Act also would prohibit a depository institution from engaging in the business of insurance, including writing insurance or providing reinsurance, or any insurance-related activity. The Act has been referred to the House Committee on Financial Services.



OTHER NEWS

SEC Staff Evaluating the Use of Derivatives by Funds

On March 25, 2010, the SEC staff announced that it is conducting a review evaluating the use of derivatives by mutual funds, exchange-traded funds and other investment companies. The review will examine whether and what additional protections are necessary to protect those funds under the 1940 Act. Pending completion of the review, the staff decided to defer consideration of exemptive requests from ETFs that would make significant investments in derivatives. The decision affects new and pending exemptive requests from certain actively-managed and leveraged ETFs that use swaps and other derivative instruments to achieve their investment objectives. The deferral does not affect any existing ETFs or other types of fund applications.

The staff generally intends to explore issues related to the use of derivatives by funds, including, among other things, whether: (1) current market practices involving derivatives are consistent with the leverage, concentration and diversification provisions of the 1940 Act; (2) funds that rely substantially upon derivatives maintain and implement adequate risk management and other procedures in light of the nature and volume of derivatives transactions; (3) fund boards are providing appropriate oversight of the use of derivatives by funds; (4) existing rules sufficiently address the proper procedure for a fund's pricing and liquidity determinations regarding its derivatives holdings; (5) existing prospectus disclosures adequately address the particular risks created by derivatives; (6) funds' derivative activities should be subject to special reporting requirements; and (7) changes in SEC rules or guidance may be warranted.

Closed-End Fund May Not Exclude Shareholder Proposal to Amend Bylaws Directing Board to Terminate Advisory Agreement

On March 5, 2010, the SEC staff refused to grant a no-action request by Boulder Total Return Fund, Inc., a closed-end fund, which would have permitted the fund to exclude from its proxy statement a shareholder proposal to amend the fund's bylaws to provide that if a court or regulatory authority determined that the fund had overvalued by a margin of greater than 5% an aggregate of at least \$1 million of the fund's auction rate preferred securities, then the board, subject to its fiduciary duties, would terminate the fund's investment advisory agreement as soon as reasonably practicable.

First, the fund argued that the proposal may be omitted because it would violate federal securities laws. The fund characterized the proposal as an attempt to "end-run" the shareholder voting requirements of the 1940 Act by "essentially amending the termination provisions of the Advisory Agreement through a change to the Fund's bylaws rather than via the Advisory Agreement." The SEC staff did not agree with the fund and noted that the proposal provides for a bylaw amendment that would direct the board to take action subject to its fiduciary duties.

Second, the fund argued that the proposal may be omitted because it is not a proper subject under Maryland law. The SEC staff did not consider this argument because the fund's letter to the SEC did not represent whether the attorney was a member of the Maryland bar.

Finally, the fund argued that the proposal may be omitted because it is not relevant to the fund's operations, or alternatively, because it deals with a matter relating to the fund's ordinary business operations. The SEC staff did not agree with the fund and noted that the events in the proposed bylaw amendment are relevant to the fund's operations and go beyond ordinary business operations.

IDC Issues Task Force Report on Board Oversight of Subadvisers

On January 28, 2010, the Independent Directors Council issued a task force report, "Board Oversight of Subadvisers." The report discusses: (1) the business reasons for retaining a subadviser and industry trends in the use of subadvisers; (2) board evaluation of the principal adviser's recommendation and due diligence in retaining a new subadviser, along with resolving any board member independence issues and the process for communicating and reporting to the board; (3) board approval of a subadvisory agreement, including an assessment of the services under the subadvisory agreement and the subadvisory fees (including profitability); (4) the integration of a subadviser into a fund's business practices and processes, including operations, valuation, proxy voting and soft dollars; (5) a board's ongoing oversight of a subadviser, including assessing the subadviser's investment performance and compliance program; and (6) the termination of a subadviser. The report also provides documents, including an outline of various tasks that may be delegated to a subadviser and some of the common provisions found in subadvisory agreements, a sample compliance certification and a sample compliance questionnaire.

The IDC task force report is available on the IDC's website at http://www.idc.org/pdf/idc_10_subadvisers.pdf.

SEC Makes Enforcement Changes

On January 13, 2010, the SEC announced new enforcement initiatives, including an "enforcement cooperation initiative" and five national specialized units that focus on complex areas of securities laws. The cooperation initiative permits enforcement staff to make deferred prosecution and non-prosecution agreements between the SEC and a cooperator pursuant to which the SEC agrees to forego or not pursue an enforcement action against the cooperator if that person agrees to cooperate fully and truthfully and comply with express undertakings. In addition, the SEC enforcement staff may agree in writing to recommend to the SEC that a cooperator receive credit for cooperating in investigations or related enforcement actions if the cooperator provides substantial assistance to the staff. In the past, all of these agreements were informal.

The new specialized units include an asset management unit, which will focus on investigations involving investment advisers, mutual funds, hedge funds and private equity funds. The other four new units include: (1) market abuse, (2) structured and new products, (3) foreign corrupt practices and (4) municipal securities and public pensions. The new units were created to provide additional resources and expertise for enforcement staff. As part of the enforcement changes, a new Office of Market Intelligence also was created that is responsible for the collection, analysis and monitoring of tips that the SEC receives.

ENFORCEMENT ACTIONS

SEC Charges Madoff's Director of Operations with Falsifying Accounting Records and Siphoning Investor Funds

On February 25, 2010, the SEC charged Daniel Bonventre, Director of Operations at Bernard L. Madoff Investment Securities LLC ("BMIS") who was responsible for running the back office and overseeing the firm's accounting and securities clearing functions for at least 30 years, with falsifying accounting records to enable the firm's multi-billion dollar fraud and illegally enrich himself, Bernard Madoff and Mr. Madoff's family and other employees. According to the SEC's complaint, Mr. Bonventre disguised Mr. Madoff's fraud and the financial losses at Mr. Madoff's firm by misusing and improperly recording investor money to create the false appearance of legitimate income.

The SEC alleged that Mr. Bonventre knew that billions of dollars in investor funds were not being used to purchase securities on behalf of investors. The SEC also alleged that Mr. Bonventre made at least \$1.9 million in illicit personal profits from the scheme through fake, backdated "trades" in his own investor account at BMIS.

According to the SEC's complaint, Mr. Bonventre was responsible for the firm's general ledger and financial statements that were materially misstated because they did not reflect the manner in which investor funds were maintained and used. Among other things, the SEC's complaint seeks financial penalties and a court order requiring Mr. Bonventre to disgorge his ill-gotten gains.

SEC Charges State Street for Misleading Investors About Subprime Mortgage Investments

On February 4, 2010, the SEC charged State Street Bank and Trust Company with misleading its investors about their exposure to subprime investments while selectively disclosing more complete information to specific investors. According to the SEC's complaint, State Street established its Limited Duration Bond Fund in 2002 and marketed it as an "enhanced cash" investment strategy that was an alternative to a money market fund for certain types of investors.

According to the complaint, the fund was almost entirely invested in subprime residential mortgage-backed securities and derivatives that magnified its exposure to subprime securities by 2007. However, State Street continued to describe the fund to prospective and current investors as having better sector diversification than a typical money market fund, and failed to disclose the extent of the fund's concentration in subprime investments.

According to the SEC's complaint and order, State Street sent investors a series of misleading communications beginning in July 2007 concerning the effect of the turmoil in the subprime market on the fund and other State Street funds that invested in it. At the same time, however, State Street provided particular investors (including clients of State Street's internal advisory groups) with more complete information about the fund's subprime concentration and other problems with the fund. The SEC alleged that, based on this more complete information, State Street's internal advisory groups subsequently decided to recommend that all of their clients redeem their investments from the fund and the related funds. The SEC also alleged that State Street sold the fund's most liquid holdings and used the cash it received from these sales to meet the redemption demands of better informed investors, leaving the fund and its remaining investors with largely illiquid holdings.

Under the terms of the settlement, State Street agreed to pay a \$50 million penalty, more than \$8.3 million in disgorgement and prejudgment interest and more than \$255 million in additional payments to compensate investors. Combined with the nearly \$350 million that State Street has already paid or agreed to pay some investors through settlements of private lawsuits, the total compensation to harmed State Street investors is approximately \$663 million.

SEC Charges Advisers for Unlawful Short Selling Practices

On January 26, 2010, the SEC settled charges against two investment advisory firms for engaging in improper short selling of securities in advance of their participation in a company's secondary offering. The cases mark the first filed under the SEC's amended Rule 105 of Regulation M, which is designed to prohibit manipulative short selling ahead of follow-on securities offerings.

In one case, the SEC charged AGB Partners LLC and its principals, Gregory A. Bied and Andrew J. Goldberger, finding that they netted thousands of dollars in improper profits by shorting in advance of their purchase of stock in a secondary offering. In the other case, the SEC charged Palmyra Capital Advisors LLC, finding that the firm violated short selling rules and improperly profited in three of its hedge funds.

The SEC alleged that AGB Partners violated both the pre- and post-amendment Rule 105 to gain illicit profits. According to the SEC's order, AGB Partners used secondary offering shares in April 2007 to cover a portion of a short position in Boots & Coots International Well Control, Inc. In June 2008, under the amended rule, AGB Partners sold short shares of BGC Partners, Inc. and then purchased BGC shares in the

company's secondary offering. AGB Partners, Mr. Bied and Mr. Goldberger agreed to pay more than \$50,000 in disgorgement and penalties.

The SEC alleged that Palmyra violated Rule 105 in connection with short sales made in advance of a public offering by Capital One Financial Corp., resulting in improper profits of \$225,500. Palmyra sold short a total of 50,000 shares of Capital One stock six days before receiving 50,000 shares from Capital One's secondary offering. Palmyra agreed to pay more than \$330,000 in disgorgement and penalties.

SEC Files Settled Insider Trading Charges Against Evergreen Insider

On January 20, 2010, the SEC filed a settled enforcement action charging Charles J. Marquardt with insider trading in the Evergreen Ultra Short Opportunities Fund, a mutual fund that invested primarily in mortgage-backed securities. At the time of his trading, Mr. Marquardt was the Senior Vice President and Chief Administrative Officer for operations of Evergreen Investment Management Company, LLC, the investment adviser to the fund.

The SEC's complaint alleged that, on June 11, 2008, Mr. Marquardt learned that the fund might soon reduce the value it assigned to several of its mortgage-backed securities holdings, a move that would likely decrease the fund's net asset value and might cause the fund to close. The SEC's complaint further alleged that, on the next day, Mr. Marquardt and another family member redeemed all of their fund shares. Over the next several days, the fund did, in fact, decrease the value it assigned to its holdings, triggering significant reductions of the fund's NAV. On June 19, 2008, Evergreen publicly announced that the fund would be liquidated. The SEC's complaint alleges that, by redeeming their fund shares prior to the announcement of the liquidation of the fund, Mr. Marquardt and his family member avoided losses of approximately \$4,803 and \$14,304, respectively. Mr. Marquardt agreed to pay \$19,107 in disgorgement, representing the losses that he and his family member avoided, \$1,242 in prejudgment interest and a \$19,107 civil penalty.

SEC Settles Charges Against Adviser's CFO/CCO for Aiding and Abetting Adviser's Fraud

On January 5, 2010, the SEC settled charges against Mary Beth Stevens for her role in the misappropriation of funds belonging to the clients of AA Capital Partners, Inc., a registered investment adviser. According to the SEC, between 2004 and 2006, Ms. Stevens aided and abetted AA Capital and its president, John Orecchio, in misappropriating more than \$23 million of investor funds. The SEC found that, in May 2004, Mr. Orecchio approached Ms. Stevens and told her that he owed a significant amount of money to the IRS based on his ownership interest in one of AA Capital's affiliated private equity funds and a failure by AA Capital's auditors to timely file certain tax returns. At Mr. Orecchio's direction, she withdrew over \$600,000 from AA Capital's client trust accounts, deposited the funds into AA Capital's main operating bank account and then wired the money to Mr. Orecchio's personal bank account. Other alleged

violations include at least 20 separate disbursements to Mr. Orecchio between May 2004 and October 2005, totaling over \$5.7 million, for the purported tax liability, including wiring funds directly to the bank accounts of two entities in which Mr. Orecchio had a personal interest, a Michigan horse farm and a company which managed a Detroit strip club. The SEC also found that Ms. Stevens falsified the account statements she sent to AA Capital's clients in order to conceal the improper withdrawals. As a result of these actions, Ms. Stevens agreed to pay disgorgement of \$79,583.50, prejudgment interest of \$22,472.24 and civil penalties of \$50,000.

SEC Settles Charges Against Investment Adviser Representative for Aiding and Abetting and Causing Morgan Stanley's Advisers Act Violation

On January 4, 2010, the SEC settled charges against William Keith Phillips for aiding and abetting and causing Morgan Stanley & Co. Incorporated's Advisers Act violation. According to the SEC, from at least 2000 through April 2006, Mr. Phillips worked as a financial adviser at Morgan Stanley, which serviced individual retail advisory clients as well as several institutional brokerage customers.

During the relevant time period, Morgan Stanley offered advisory clients a program called Vision I. Morgan Stanley's disclosure materials regarding Vision I described the advisory services it provided which included assisting clients in identifying money managers to manage clients' assets. Morgan Stanley disclosed the detailed due diligence process it followed to select and approve money managers for participation in Vision I. According to its disclosure materials, Morgan Stanley financial advisers selected money managers from this approved list of managers to recommend to clients based on the client's investment profile and objectives.

According to the SEC, Mr. Phillips recommended to certain advisory clients of Morgan Stanley certain money managers who were not approved for participation in Vision I and had not been subject to the firm's due diligence review, which fact was not disclosed to those advisory clients. The SEC also found that Mr. Phillips had undisclosed relationships with the money managers who had not been approved by Morgan Stanley from which Mr. Phillips and Morgan Stanley received substantial brokerage commissions and/or fees. As a result of these actions, Mr. Phillips agreed to pay an \$80,000 penalty.

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

