Investment Services Regulatory Update

May 3, 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. On April 20, 2010, Schwab announced that it signed a memorandum of understanding with the plaintiffs to settle their claims for $200 million. The preliminary settlement is subject to final court approval.

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)."

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.

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.

OTHER NEWS

Mutual Fund Directors Forum Issues Practical Guidance for Fund Directors on Effective Risk Management Oversight

On April 15, 2010, the Mutual Fund Directors Forum issued a report entitled “Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight.” The report provides an overview of the role that mutual fund directors play in risk oversight and seeks to provide boards with a better understanding of their responsibilities in the area of risk governance. The guidance is designed to help fund directors better understand how risk can be managed in the mutual fund business and to help directors assess whether, given the specific facts relevant to the funds they oversee, their funds' adviser and other service providers address risk in a manner that protects the interests of fund shareholders. The report included the following guidance for fund directors:

- Directors need to understand risk so that they can evaluate intelligently what risks to assume and manage those risks appropriately.
- While fund directors generally cannot be expected to directly identify and analyze risks, their oversight responsibility impels them to ask whether the adviser has appropriate systems and processes in place for identifying, analyzing and managing risk, including the particular market, credit, legal, fiduciary, reputational, operational, organizational and other risks applicable to the funds they oversee.
- Risk oversight by the board should involve an assessment of the adviser's culture and risk awareness and should encourage the implementation and continuous improvement of a robust process for identifying, managing, prioritizing and monitoring the fund’s risks.
- Directors should seek to understand the "risk appetite" of each fund and how that risk appetite is rooted in investor expectations and affected by changing market conditions. Directors should understand how policies set at the board level relate to a fund’s “risk appetite” and should be satisfied that a robust and responsive process is in place to periodically review and revise risk tolerances set forth in fund guidelines, such as position limits, counterparty credit limits, concentration limits and valuation policies.
- Directors should examine whether the adviser’s organizational structure provides adequate checks and balances, including appropriate segregation of front, back and middle-office functions.
- Given the current focus on risk management, fund directors may wish to ask whether a chief risk officer and/or dedicated risk management staff is

appropriate or necessary, taking into account the size and complexity of the fund and the adviser.

- Fund directors should satisfy themselves that there is a process in place for reviewing the issues raised by new products and strategies before being implemented.

- Fund directors should seek to understand how management identifies and manages operational risk.

- Fund directors should develop a foundational understanding of the risks that arise as part of the investment management process and should be satisfied that the adviser is effectively managing those risks. Directors should ensure that they have access to a variety of information that facilitates an understanding of how investments are performing, as well as the various risks that they entail.

- Directors should assess whether investment performance and investment risk are being monitored in a meaningful way. Directors should focus on specific policies that drive fund performance and should be mindful of how much risk is being undertaken to generate incremental performance.

- Directors should focus their attention on valuation of investments, the use of complex securities and issuer and counterparty risk.

- Directors should consider the use of a risk matrix or risk inventory to ensure that an effective, thorough and thoughtful appraisal of areas of risk applicable to the fund and its adviser is being conducted.

The report concludes by acknowledging that because the circumstances and risks of funds vary greatly, there can be no single solution to ensure effective risk oversight by directors. To help directors in evaluating their current risk oversight capabilities and identify areas in which they can improve, the guidance includes exhibits which provide specific questions that directors can ask to address the topics covered within the report. The report is available at: http://www.mfdf.com/images/uploads/resources_files/MFDFRiskPrinciplesforFundDirectorsApril2010.pdf.

IDC Issues Memorandum on Board Oversight of Target Retirement Date Funds

On April 28, 2010, the Independent Directors Council issued a memorandum, "Board Oversight of Target Retirement Date Funds," to assist target date fund directors in performing their oversight responsibilities. The memorandum provides a list of topics and potential questions that boards may wish to ask advisers in connection with target date fund oversight. The three main topics covered by the memorandum are (i) fund performance, (ii) approval of advisory contract and advisory fees and (iii) fund disclosure and distribution.

The IDC memorandum is available on the IDC's website at http://www.ici.org/idc/idc_directors_resources/idc_public_other_publications/10_idc_trdf.

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.

ENFORCEMENT ACTIONS

FINRA Fines HSBC Securities (USA) and US Bancorp Investments for Auction Rate Securities Violations

On April 22, 2010, FINRA announced that it had settled charges with HSBC Securities (USA) and US Bancorp Investments, Inc. arising from the sale of auction rate securities ("ARS"). FINRA's findings centered on the firms' failure to adequately disclose the risks associated with ARS, leaving customers "unprepared for the failure of the auction market." To date, FINRA has reached ARS-related settlements with 14 firms and has imposed close to $5 million in fines, returning more than $2 billion to investors. The fines for HSBC and US Bancorp were $1.5 million and $275,000, respectively.

FINRA found that as late as December of 2007, and despite the fact that it had become apparent to HSBC that credit markets were deteriorating, HSBC continued to recommend and sell ARS to customers, representing that the securities were liquid and safe investments. Additionally, FINRA concluded that the subsequent measures taken by HSBC to notify its brokers of the risks associated with ARS were inadequate. The findings against US Bancorp related to certain of US Bancorp's internal marketing materials, which were prepared by other securities firms. According to FINRA, these materials, which described ARS as "a great place for short term money" and a "cash alternative," failed to provide balanced and/or adequate disclosure of the risks of these securities. Some materials used by the firm compared the yields of money market securities and ARS without disclosing material differences between the securities, such as liquidity risk and the potential for fluctuation of returns.

FINRA Files Complaint Against Morgan Keegan for Misleading Customers Regarding Risks of Bond Funds

On April 7, 2010, FINRA announced that it had filed a complaint against Morgan Keegan & Company seeking a fine, disgorgement of profits and full restitution to customers in connection with the marketing and selling of seven affiliated bond funds to investors. The complaint alleges that the firm used false and misleading sales materials to market the funds and that deficient internal guidance and broker training caused Morgan Keegan's brokers to make material misrepresentations to investors. FINRA's complaint

also asserts that although Morgan Keegan became aware in early 2007 that problems in the mortgage-backed securities markets were having an adverse and disproportionate effect on these bond funds, the firm neither warned its brokers nor revised its advertising materials to reflect the material risks unique to these securities. From January 1, 2006 through December 31, 2007, Morgan Keegan sold over $2 billion in shares of the bond funds, which invested heavily in structured products including subordinated tranches of asset-backed securities and mortgage-backed securities with sub-prime exposure.

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.

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