VEDDERPRICE

Investment Services Regulatory Update

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LITIGATION

Funds Face Lawsuits Over Payments to Distributors; California Court Dismisses First Case

In the last few months, several lawsuits have challenged payments made to broker-dealers who are not also registered as investment advisers in connection with the distribution of fund shares. The lawsuits, which are derivative actions on behalf of the funds, allege payment of asset-based compensation to broker-dealers holding fund shares in brokerage accounts. The claims are based on the March 30, 2007 decision in *Financial Planning Association v. SEC*, in which the D.C. Circuit Court of Appeals overturned a rule under the Advisers Act permitting fee-based brokerage accounts for certain broker-dealers. Under federal securities laws, broker-dealers may not receive compensation based on a percentage of assets in a client's account unless they are registered under the Advisers Act.

According to the lawsuits, pursuant to the 1940 Act and Rule 38a-1 (the compliance program rule), the board of a mutual fund has ultimate responsibility for ensuring compliance with all federal securities laws. Each complaint alleges that by authorizing payments not permitted under the Advisers Act, the funds and their boards have abdicated their duties under Rule 38a-1. The lawsuits generally assert a claim under Section 47(b) of the 1940 Act against each fund's distributor that seeks to void the existing distribution agreement, a breach of contract action against each distributor and claims for breach of fiduciary duty and waste against the funds' directors.

On June 8, 2010, the U.S. District Court for the Northern District of California dismissed claims made against Franklin Templeton, although the decision provides until July 7, 2010 for the plaintiff to amend the complaint with respect to the sole federal claim. In her ruling, the judge disagreed with the theory that Section 47(b) of the 1940 Act provides a separate cause of action or basis of liability for a claim, as well as the plaintiff's reading of the D.C. Circuit Court of Appeals case regarding fee-based brokerage accounts. The opinion noted that, in the absence of some other violation of the 1940 Act, Section 47(b) alone is insufficient to support a private right of action. In characterizing the *Financial Planning Association* decision as "irrelevant" to the claims before the court, the judge distinguished the service-based fees that violate the prohibition on asset-based compensation from distribution fees paid by Franklin Templeton under Rule 12b-1.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Adopts New Rule to Curtail Adviser "Pay to Play" Practices

On June 30, 2010, the SEC adopted a new rule intended to restrict "pay to play" practices by investment advisers seeking to manage money for state and local government public programs. The rule is designed to prevent investment advisers from

using direct political contributions and other pay to play arrangements to attempt to influence their selection by government officials.

Specifically, the rule:

- Subject to a de minimis provision for executives and employees of the adviser, bars an adviser who makes a political contribution to an elected official in a position to influence the selection of the adviser for two years from providing advisory services for compensation, either directly or through a fund;
- Prohibits an adviser from soliciting others to make contributions to an elected official or candidate who can influence the selection of the adviser or to a political party where the adviser is seeking to provide advisory services to the government;
- Prohibits an adviser from paying third party solicitors to solicit government clients on behalf of the adviser; and
- Prohibits an adviser from engaging in pay to play practices indirectly, for example, through affiliated companies, lawyers or spouses, if the conduct would violate the rule if the adviser did it directly.

The rule becomes effective 60 days after its publication in the Federal Registrar and compliance with the rule generally will be required within six months of the effective date. Compliance with the prohibition on third party solicitors and with provisions applicable to advisers to registered investment companies subject to the rule will be required one year after the effective date.

NFA Proposes Amendment to Restrict Exclusions from the Commodity Pool Operator Definition for Investment Companies

On June 29, 2010, the National Futures Association submitted a petition for rulemaking to the Commodity Futures Trading Commission that would amend CFTC Rule 4.5, which provides an exclusion from the definition of commodity pool operator for eligible persons operating certain qualified entities, including registered funds. The proposed amendment would restore restrictions that are substantially similar to those in effect prior to 2003. Prior to 2003, persons seeking to fit within the exclusion were required to file a notice of eligibility and represent that the qualifying entity (1) has not marketed, and will not market, participations to the public as or in a commodity pool or otherwise as a vehicle for trading commodity futures or commodity options and (2) will use commodity futures or commodity options contracts solely for bona fide hedging purposes and that the aggregate initial margin and premiums for positions not held for bona fide hedging purposes will not exceed 5% of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and losses on all such contracts.

SEC Proposes Amendments Regarding Target Date Fund Marketing Materials

On June 16, 2010, the SEC proposed rule amendments that would require target date funds to include additional risk and asset allocation information in marketing materials. Specifically, the proposed amendments would require:

- A target date fund that includes the target date in its name to disclose the fund's projected asset allocation at the target date immediately adjacent to (or, in the context of radio or television advertisements, immediately following) the first use of the fund's name in marketing materials;

- All target date funds to include a table, chart or graph depicting the fund's asset allocation over time ("glide path") and a statement highlighting the fund's final asset allocation ("landing point"). Immediately preceding the table, chart or graph, disclosure would be required explaining that the asset allocation of the target date fund changes over time, noting that the asset allocation eventually becomes final and stops changing, stating the number of years after the target date at which the asset allocation becomes final and providing the final asset allocation; and

- All target date funds to include disclosure advising an investor:

  - to consider, in addition to age or retirement date, other factors, including the investor's risk tolerance, personal circumstances and complete financial situation,

  - an investment in a target date fund "is not guaranteed and it is possible to lose money" by investing in the fund, including after the target date, and

  - unless disclosed as part of the disclosure preceding the table, chart or graph, a statement as to whether, and the extent to which, the intended percentage allocations of a target date fund may be modified among types of investments without shareholder approval.

The SEC's proposed amendments define a "target date fund" to include all funds that hold themselves out to investors as target date funds, including those without a date in their names. The proposed amendments also would define and distinguish between a target date fund's "target date" and its "landing point."

The SEC also proposed an amendment to Rule 156 under the Securities Act, which would provide additional guidance to all funds regarding whether certain statements contained in marketing materials could be characterized as misleading. Specifically, Rule 156 would be amended to add the following as factors to consider:

- whether the statement emphasizes a single factor (such as an investor's age or tax bracket) as the basis for determining that an investment is appropriate; or

- whether the statement makes express or implied representations that investing in the security is a simple investment plan that requires little or no monitoring by the investor.

Comments on the proposal are due by August 23, 2010.

Implementation of Identity Theft Prevention Programs Further Delayed Until December 31, 2010

On May 28, 2010, the Federal Trade Commission announced that it would suspend enforcement of the red flags rule under the Fair and Accurate Credit Transactions Act of 2003, which imposes identity theft-related requirements on "financial institutions" and other specified entities, until December 31, 2010. This is the fifth time the FTC has delayed implementation of the rule.

LEGISLATION

Senate Approves Restoring American Financial Stability Act of 2010

On May 20, 2010, the Senate passed the Restoring American Financial Stability Act of 2010. 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

Closed-End Fund Loses Battle to Omit Shareholder Proposal in Proxy Statement

On May 5, 2010, the SEC staff denied The Swiss Helvetia Fund's request for no-action relief to exclude a shareholder proposal for inclusion in the fund's proxy statement. The shareholder proposal asked the fund's board to implement an interval fund structure that would empower the board to conduct periodic tender offers with the goal of giving shareholders a chance to sell their shares at or close to net asset value. The fund argued to exclude the proposal on the grounds that the proposal had been substantially implemented because the board of directors had previously considered and rejected the adoption of an interval fund structure. The fund also argued that including the proposal

would constitute a violation of law to submit a proposal that the board deems to be against the shareholders' best interest. In addition, the fund argued that the proposal should be excluded because it relates to the fund's ordinary business operations, it is vague and indefinite and that certain parts of the proposal are false or misleading. The SEC staff stated that they were unable to concur with the fund's view to exclude the proposal but did not detail the reasons for dismissing the fund's arguments.

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.

ENFORCEMENT ACTIONS

Fund Portfolio Manager Charged with Tipping Family Members

On May 11, 2010, the SEC initiated administrative proceedings against David W. Baldt due to his alleged disclosure of material non-public information concerning the Schroder Short-Term Municipal Bond Fund. During 2003 to 2008, Mr. Baldt served as portfolio manager of the Fund. According to the SEC order, several members of Mr. Baldt's family invested the bulk of their life savings in the Fund and during the deteriorating market conditions of late 2008, Mr. Baldt told a family member that she should sell her shares and that she should tell another family member the same.

Specifically, the SEC alleged that on September 17, 2008, one of Mr. Baldt's family members called him for advice about what to do with her investment in the Fund. He allegedly advised her that, if her concerns about the investment were preventing her from sleeping at night, she should sell her investment and invest in U.S. Treasury bills. In addition, Mr. Baldt allegedly told that family member that she should tell a second family member to do the same. According to the SEC, the same family member and Mr. Baldt had another conversation on October 3, 2009, in which Mr. Baldt told her that she "really should consider [her] inclination to sell" her Fund shares. When the family member noted that she had already started selling subsequent to their September 17th conversation, Mr. Baldt allegedly emphasized that she should "go the full route" and told her to tell the second family member to do the same.

As a result, family members redeemed approximately $200,000 in Fund shares between October 6th and 7th. Subsequently, Mr. Baldt's family members attempted, but failed, to redeem $3,068,117 worth of Fund shares as the Fund gave shareholders notice that it was liquidating on October 14, 2008 and suspending cash redemptions.

According to the SEC order, at the time of his October 3rd conversation with his family member, Mr. Baldt possessed material non-public information concerning the Fund since he knew that the Fund was receiving mounting and significant redemption requests at a time when sales of portfolio securities were adding downward pressure on municipal bond prices, management had given him a directive to keep 10 to 20% of the Fund's assets in cash, redemption requests were likely to increase as the Fund's adviser was putting out a large percentage of its municipal bond portfolio to bid and that liquidating the Fund was a potential option.

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.

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