Investment Services Regulatory Update

October 4, 2010

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Stays Effectiveness of Amendments to Proxy Rules that Facilitate Rights of Shareholders to Nominate Directors

On October 4, 2010, the SEC ordered a stay of the effect of proxy rules adopted on August 25, 2010 that enhance the rights of shareholders to nominate directors for corporate boards, including boards of investment companies. The stay was granted in response to a petition by the Business Roundtable and the U.S. Chamber of Commerce pending resolution of court challenges to the rules that they filed on September 29, 2010 with the Court of Appeals for the District of Columbia Circuit.

The amendments create Rule 14a-11 under the Exchange Act, which allows eligible shareholders to have their nominees included in a company's proxy materials. Shareholders must meet all the requirements of Rule 14a-11 to have their nominee included in a company's proxy materials and Rule 14a-11 is not available if applicable state law or the company's governing documents prohibit shareholders from nominating candidates to the board. In addition, the amendments modify Rule 14a-8 under the Exchange Act to allow shareholders, subject to the other requirements of the Rule, to include proposals in a company's proxy materials that would amend provisions of a company's governing documents concerning the company's director nomination procedures or other director nomination disclosure provisions.

Pursuant to new Rule 14a-11, a shareholder is eligible to have a nominee included in a fund's proxy materials if the shareholder provides proper notice to the fund and, as of the date of such notice: (1) owns at least 3% of the outstanding fund voting securities entitled to vote on the election of directors at the meeting, (2) continuously held securities equaling the 3% threshold for at least three years prior to the notice date and (3) continues to hold the securities through the date of the shareholders meeting. Rule 14a-11 allows multiple shareholders to aggregate their individual holdings to meet the minimum ownership threshold, but each shareholder in the group must have held their qualifying shares for the required three-year period and must continues to hold their shares through the meeting date. For purposes of Rule 14a-11, unless a fund is a series company, a shareholder may determine the total amount of voting power of a fund's securities entitled to vote on the election of directors by reference to information included in the fund's most recent annual or semi-annual report on Form N-CSR. For a fund that is a series company, the fund must file a Form 8-K within four business days of setting a meeting date disclosing the total number of shares outstanding and entitled to vote on the election of directors as of the end of the most recent calendar quarter.

In addition to the ownership requirements, under Rule 14a-11, shareholders must certify that they are not holding their shares for the purpose of gaining control of the company or to gain more than a minority representation on the board of directors. An eligible shareholder is allowed to have one nominee or a number of nominees that would represent 25% of a company's board of directors, whichever is greater, included in the company's proxy materials. A nominating shareholder is required to file Schedule 14N with the SEC, which includes the information and certifications required by Rule 14a-11. A company that includes shareholder nominees in its proxy materials is not liable for any false or misleading statements in information provided by the nominating shareholder unless the company knows or has reason to know the information is false or misleading.

Pending resolution of the request for expedited review of the rules by the D.C. Court of Appeals, the amendments become effective on November 15, 2010.

SEC Amends Regulation FD as Required by the Dodd-Frank Act

On September 29, 2010, the SEC adopted an amendment to Regulation FD to remove the exemption from public disclosure of material nonpublic information provided to nationally recognized statistical rating organizations (NRSROs) and credit rating agencies solely for the purpose of determining or monitoring a credit rating. The SEC amended Regulation FD to comply with a specific directive included in the Dodd-Frank Act that the exemption for information provided to NRSROs and credit rating agencies be removed.

The amendment is effective on October 4, 2010.

CFTC Requests Comments on Amendments to Limit the Use of Futures by Investment Companies

On September 17, 2010, the CFTC issued a notice seeking comments on proposed amendments to CFTC Rule 4.5, which provides an exclusion from the term commodity pool operator for eligible persons operating certain qualifying entities, including registered funds. The proposed amendments would restore restrictions 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 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 speculative futures positions 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. The amendments would also modify the limitation on speculative futures positions from former Rule 4.5 by referring directly to the qualifying entity claiming the exclusion. This could prohibit funds from trading futures and options on futures in wholly-owned subsidiaries, unless the subsidiary has also claimed an exemption under the Rule.

Comments on the proposed amendments are due by October 18, 2010.

SEC Proposal Regarding Mutual Fund Distribution Fees

On July 21, 2010, the SEC proposed a new rule and rule amendments relating to the regulation and disclosure of mutual fund distribution fees. Specifically, the proposal would replace Rule 12b-1 under the 1940 Act with new and amended rules that would:

- place limits on the cumulative sales charges paid to mutual funds by investors;
- require increased disclosure in fund prospectuses, semi-annual and annual reports and confirmation statements;
- allow mutual funds to sell shares through broker-dealers who establish their own sales charges with respect to such sales; and
- eliminate the need for mutual fund directors to explicitly approve and annually reconsider 12b-1 plans.

The SEC's proposal would rescind Rule 12b-1 in its entirety and instead permit funds to deduct asset-based distribution fees pursuant to proposed Rule 12b-2 and amended Rule 6c-10. The SEC proposal divides asset-based distribution fees into two categories: (1) "marketing and service fees" of up to 0.25% per year and (2) "ongoing sales charges" for amounts greater than 0.25% per year. Marketing and service fees could be paid out of fund assets for distribution-related expenses such as participation in fund supermarkets, maintenance of shareholder accounts and marketing and distribution strategies, up to the amount allowed for funds to be described as "no load" under FINRA Conduct Rule 2830 (currently 0.25% per year). A mutual fund's board of directors would not be required to adopt a formal plan related to such marketing and service fees, but shareholder approval would be required before a fund could institute or increase the rate of a marketing and service fee.

Ongoing sales charges—those payments out of fund assets in excess of 0.25% per year—would be treated like a sales load and limited, cumulatively, to the highest front-end sales load charged for that fund (or in the absence of a share class with a front-end sales load, a FINRA Conduct Rule-based aggregate cap of 6.25%). For example, if one class of a mutual fund charges a 4% front-end sales load, another class could not charge more than 4%, cumulatively, in ongoing sales charges to investors over time. A fund that has ongoing sales charges may satisfy its obligations to observe this limit by automatically converting to a class of shares with no ongoing sales charge once the cap has been reached. Additionally, under the proposal, ongoing sales charges could not be instituted or increased after any public offering of a mutual fund's shares or the sale of such shares to persons who are not organizers of the fund.

The SEC's proposal also would increase disclosure related to distribution fees. The proposal would amend Form N-1A to modify the fee table requirements to separate the disclosure of asset-based distribution fees into two component fees. Specifically, the

SEC proposal would replace the current heading relating to distribution fees (i.e., "12b-1 Fees") with the heading "Ongoing Sales Charge" and would add a new subheading under "Other Expenses" called "Marketing and Service Fee." Additionally, the proposal would eliminate the SAI requirement to describe the material aspects of any 12b-1 plans.

The SEC also proposed to amend Rule 10b-10 under the Exchange Act to require, among other items, disclosure of front-end and deferred charges, as well as ongoing sales charges and marketing and service fees by broker-dealers, in confirmations relating to mutual fund transactions. Certain other changes to Rule 10b-10 concerning callable debt securities are also proposed, such as disclosure requiring the first date on which debt securities held in a fund's portfolio may be called. In a footnote, the SEC added that it was also contemplating whether to require point of sale disclosure for mutual fund purchases based on new authority in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Citing a need to encourage and increase retail price competition among mutual funds, the SEC proposed to amend Rule 6c-10 under the 1940 Act to allow mutual funds to sell shares through broker-dealers who establish their own charges, subject to competition in the marketplace. Under the proposal, broker-dealers could establish their own sales charges, tailor them to different levels of shareholder service and charge shareholders directly, similar to the manner in which commissions are charged on other securities such as common stock. To prevent an investor from being double-charged, classes of shares sold in reliance on this exemption could not be subject to any other sales charges but could impose a marketing and service fee.

Finally, under the proposal, mutual fund directors would no longer be required to explicitly approve and annually re-approve a fund's distribution arrangements. However, directors would continue to be responsible for overseeing ongoing sales charges, as well as marketing and service fees, in accordance with their general fiduciary duties. Furthermore, the proposal would permit grandfathering of Rule 12b-1 fees for a period up to five years after the compliance date of Rule 12b-2. In such a case, a mutual fund's board of directors would be permitted to vote to eliminate the provisions in the fund's 12b-1 plan requiring annual board approval.

Comments on the proposals are due by November 5, 2010.

SEC Adopts Amendments to Part 2 of Form ADV

On July 21, 2010, the SEC adopted amendments to Part 2 of Form ADV, and related rules under the Advisers Act, that require investment advisers registered with the SEC to deliver to clients and prospective clients a narrative brochure written in plain English rather than the current "check-the-box" format supplemented with narrative responses. The narrative brochure is intended to provide investors with more detailed information about an investment adviser's business practices, fees, conflicts of interest and disciplinary history. This brochure includes the following 18 separate items, each covering a different disclosure topic: (1) cover page; (2) material changes; (3) table of contents; (4) advisory business; (5) fees and compensation; (6) performance-based fees and side-by-side management; (7) types of clients; (8) methods of analysis, investment strategies and risk of loss; (9) disciplinary information; (10) other financial industry activities and affiliations; (11) code of ethics, participation or interest in client transactions and personal trading; (12) brokerage practices; (13) review of accounts; (14) client referrals and other compensation; (15) custody; (16) investment discretion; (17) voting client securities; and (18) financial information. Advisers are required to respond to each item in the order presented in the form using the headings provided.

Advisers must file their brochures with the SEC electronically through the IARD system annually and on an interim basis for material updates, and the SEC will make them available to the public through its website. Advisers are still required to deliver their brochure to clients at the beginning of the advisory relationship and also are required to deliver a brochure to existing clients annually and on an interim basis for any updates to disciplinary information. The annual delivery to existing clients could be accomplished by delivering no later than 120 days after the adviser's fiscal year end either: (1) a copy of the adviser's current brochure and a summary of material changes or (2) a summary of material changes and an offer to provide the current brochure.

Advisers are required to deliver to clients brochure supplements, either included in the brochure or provided separately, which provide information on the educational background, business experience and disciplinary history of advisory personnel who provide investment advice to the client. The brochure supplement must be provided to a client at or before the time that any person that provides investment advice to the client begins to provide such advisory services. Advisers are required to deliver updated brochure supplements to clients only when there is new or amended disciplinary information and advisers are not required to deliver the brochure supplement to existing clients annually. Advisers do not have to file the brochure supplements with the SEC.

The SEC has rescinded, as duplicative, Rule 206(4)-4 under the Advisers Act, which required advisers to disclose certain disciplinary and financial information.

The rule becomes effective on October 12, 2010. Advisers applying for registration with the SEC after January 1, 2011 must file a brochure that meets the amended requirements of Part 2 as part of their application for registration and deliver the brochure and brochure supplements to existing and prospective clients in accordance with the amended rules. Existing registered advisers must file a revised brochure that meets the amended requirements as part of their annual updating amendment to Form ADV for fiscal years ending on or after December 31, 2010 and begin delivering the revised brochure and brochure supplements to new and prospective clients in accordance with the amended rules. In addition, within 60 days of filing its annual updating amendment including the revised brochure, each currently registered adviser must deliver to existing clients the revised brochure and brochure supplements.

LEGISLATION

House Passes Regulated Investment Company Modernization Act of 2010

On September 28, 2010, the House of Representatives passed the Regulated Investment Company Modernization Act of 2010, which would amend the Internal Revenue Code to modify certain rules governing the taxation of regulated investment companies ("RICs"). Among other provisions, the Act would:

- permit RICs an unlimited carryforward of their net capital losses;
- allow income from commodities to be treated as qualifying income for purposes of the RIC gross income test;
- add savings provisions for failures of RICs to satisfy the RIC gross income and asset tests;
- modify the rules for designating and allocating RIC capital gain dividends;
- permit certain nondeductible items of income to be included in a RIC's earnings and profits calculations;
- allow qualified funds-of-funds to pass through to their shareholders tax-exempt interest and foreign tax credits, without regard to certain investment limitations;
- modify the rules relating to spillover dividends, return of capital distributions and stock redemptions;
- repeal the preferential dividend rule for publicly offered RICs;
- permit RICs to defer certain late-year losses; and
- modify certain excise tax and penalty rules applicable to RICs.

Dodd-Frank Wall Street Reform and Consumer Protection Act Enacted

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, which among other provisions:

- establishes 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, if other actions fail, certain financial companies that pose a grave threat to the stability of the markets to divest some of their holdings;

- provides for the orderly liquidation of certain nonbank financial companies that are determined, subject to certain requirements, to be in default or in danger of default;

- requires investment advisers to certain unregistered investment companies (i.e., 3(c)(1) and 3(c)(7) funds) to register with and provide information to the SEC; however, investment advisers to "venture capital funds," as defined by the SEC, and to private funds with assets under management of less than $150 million are exempt from such registration requirements, but are required to maintain records and provide reports to the SEC;

- increases the asset threshold for federally-registered investment advisers to $100 million, or such higher amount determined by the SEC;

- modifies the accredited investor standard to exclude the value of a person's primary residence from the calculation of the person's net worth;

- (1) generally prohibits 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, except that such entities may engage in certain permitted activities and may make *de minimis* investments subject to certain restrictions and (2) imposes 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;

- permits the SEC to issue rules providing that the standard of conduct for broker-dealers providing personalized investment advice about securities to retail customers, and such other customers as designated by the SEC, shall be the same as the standard of conduct applicable to investment advisers;

- permits the SEC to issue rules requiring broker-dealers who sell only proprietary or other limited range of products to provide notice to their retail customers and obtain such customers' consent to such products;

- permits the SEC to issue rules requiring broker-dealers to provide documents or information to retail investors before they purchase investment products or services;

- permits the SEC to limit the use of pre-dispute arbitration provisions in broker-dealer agreements;
- requires the SEC to review and modify regulations referring to or requiring reliance on credit ratings and to substitute a standard of creditworthiness as determined appropriate by the SEC;
- subjects auditors of broker-dealers to regulation by the Public Company Accounting Oversight Board;
- permits the SEC to adopt proxy access rules requiring the inclusion of shareholder-proposed board nominees in issuer proxy solicitations; and
- requires the SEC to conduct studies on topics including (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) an evaluation of investment adviser examinations; (3) the financial literacy of retail investors; and (4) mutual fund advertising.

Congress Passes Legislation Limiting Confidentiality Protection for Materials Provided to the SEC

In September 2010, the Senate and House of Representatives each passed legislation amidst criticism that Section 929I of the Dodd-Frank Act undermines the goal of enhancing transparency and accountability in the financial system. As adopted, Section 929I modified the 1940 Act and the Advisers Act to generally provide that, with certain exceptions, the SEC shall not be compelled by a request under the Freedom of Information Act ("FOIA") to disclose any records or information it obtained in connection with its examination and surveillance efforts. The SEC had contended that such confidentiality provisions were necessary as regulated entities have refused to provide certain requested information that may not be protected by a FOIA exemption. The SEC's position failed to sway Congress and, as drafted, the current version of the legislation removes the confidentiality provisions in their entirety from the Acts.

Whistleblower Provisions Under the Dodd-Frank Act

Similar to the Sarbanes-Oxley Act, the Dodd-Frank Act includes whistleblower protections and remedial provisions for employees who suffer retaliation in connection with whistleblower actions. Unlike Sarbanes-Oxley, however, the Dodd-Frank Act does not limit such protection to employees of publicly-traded companies and provides for a private right of action in connection with a whistleblower claim.

The Dodd-Frank Act also creates incentives for securities whistleblowers. Specifically, a whistleblower, subject to certain limitations, is eligible to receive between 10% and 30% of the amount collected by the SEC in connection with any judicial or administrative action based on information provided by the whistleblower that results in monetary sanctions exceeding $1 million. The whistleblower award program provides that a whistleblower may provide such information anonymously. However, if a whistleblower both provides the information and makes a claim under the award program anonymously, the whistleblower must be represented by counsel. This requirement reportedly has resulted in increased whistleblower tips to plaintiffs' attorneys, which may be a direct result of increased attorney advertising. Of the more notable reported advertisements, a firm in New York City has begun advertising their whistleblower services in movie theaters, in particular, prior to the showing of the movie "Wall Street: Money Never Sleeps."

Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 Enacted

On July 1, 2010, President Obama signed into law the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010. The Act authorizes state and local governments, pursuant to certain requirements, to adopt and enforce measures to divest the assets of the state or local government from, or prohibit the investment of those assets in, persons, including entities, that engage in investment activities in Iran. Under the Act, a person engages in investment activities in Iran if such person has an investment of $20 million or more in the energy sector of Iran or is a financial institution that extends $20 million or more in credit, for 45 days or more, to another person that will use such credit for investment in the energy sector of Iran. Similar to the Sudan Accountability and Divestment Act of 2007, the Act amends Section 13 of the 1940 Act to create a safe harbor for investment companies that divest from or avoid investing in securities of certain issuers. The Act also amends Section 13 to provide that the safe harbors in the Act and in the 2007 Act do not create or imply a private right of action.

LITIGATION

Massachusetts Supreme Court Rules on Application of the Business Judgment Rule

On August 23, 2010, the Supreme Judicial Court of Massachusetts issued its ruling in *Helabian v. Berv*, that the business judgment rule can be applied to dismiss a derivative complaint filed timely under the Massachusetts Business Corporations Act but prior to a corporation's rejection of the demand serving as the basis for the suit. Previously, the District Court for the Southern District of New York dismissed a shareholder's derivative action for an alleged breach of fiduciary duty by the Board of CitiFund Trust in connection with the approval of new investment advisory agreements following Legg Mason Inc.'s acquisition of Citigroup's asset management business. In dismissing the suit, the district court relied upon the trustees' good-faith determination (i.e., their business judgment) that prosecuting the action would not be in the fund's best interests.

The Massachusetts Act contains a universal demand requirement that prevents shareholders from filing a derivative action until a board has had at least 90 days to evaluate the claim and make a formal recommendation. The district court found that, although the plaintiff had satisfied the demand requirement before filing suit, the Board's decision not to pursue the action required dismissal of the lawsuit, despite the fact that it came six weeks after the 90-day period for review had expired. The district court's analysis was based largely on its interpretation of a provision the Act, which states that a derivative proceeding commenced after the rejection of a demand shall be dismissed by the court on motion by the corporation.

On appeal, the Second Circuit reversed the district court's decision, but withheld judgment in the case, opting to certify a question to the Supreme Judicial Court of Massachusetts. The Second Circuit will now make a final judgment on the appeal.

Ninth Circuit Finds No Private Right of Action under Section 13 of the 1940 Act

On August 12, 2010, the Ninth Circuit reversed the district court's ruling in the case involving the Schwab YieldPlus Fund in holding that nothing in Section 13 of the 1940 Act creates a private cause of action or recognizes that one exists with the clarity and specificity required under Supreme Court precedent. In the Schwab case, 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 district court judge ruled that the fund violated Section 13 of the 1940 Act in not submitting these changes in industry classification to shareholders for approval. In its opinion, the Ninth Circuit stated that the language of Section 13, the structure of the 1940 Act and legislative history do not reflect any congressional intent to create, or recognize a private right of action, to enforce Section 13. The Ninth Circuit disagreed that the Sudan Accountability and Divestment Act's bar to particular litigation is sufficient to constitute recognition of a pre-existing private right of action that is not otherwise evident in the language or structure of the 1940 Act.

OTHER NEWS

SEC's Enforcement Head Testifies on Mutual Fund Fee Initiative

On September 22, 2010, Robert Khuzami, the head of the SEC's Division of Enforcement, discussed a "Mutual Fund Fee Initiative" during his testimony before the Senate Committee on the Judiciary. When discussing the SEC's newly-created asset management unit (which focuses on mutual funds, private funds and investment advisers), Mr. Khuzami noted that the unit, along with the other SEC divisions, has established a Mutual Fund Fee Initiative to develop analytics for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees. He stated that the analytics are expected to result in examinations and investigations of investment advisers and fund boards concerning duties under the 1940 Act.

SEC Issues No-Action Letter on Soft Dollar Arrangements

On September 21, 2010, the SEC issued a no-action letter to BNY ConvergEx Group, LLC stating that a broker-dealer's provision of research services to an institutional investment adviser would not establish an adviser-client relationship under the Advisers Act between the broker-dealer and the institutional investment adviser's clients. According to BNY ConvergEx's letter, many research broker-dealers have refused cash payments for their proprietary research from executing brokers because the investment adviser's clients may be viewed as the research broker-dealer's clients and, as a result, the principal transaction restrictions under the Advisers Act may apply.

SEC Staff Issues No-Action Letter and Interpretation under Rule 2a-7

On August 19, 2010, the SEC staff issued a no-action letter to the ICI providing that the Division of Investment Management would not recommend enforcement action against any money market fund that does not comply with the requirements concerning the designation of nationally recognized statistical rating organizations ("NRSROs") in amended Rule 2a-7 under the 1940 Act before the SEC has completed its review of Rule 2a-7 as required by the Dodd-Frank Act and made any modifications to the Rule. Rule 2a-7 amendments adopted earlier this year would require that, by December 31, 2010, a fund's board designate at least four NRSROs whose ratings would be use to determine portfolio security eligibility under the Rule and the fund disclose such NRSROs in its SAI. The Dodd-Frank Act requires the SEC to review and modify regulations referring to or requiring reliance on credit ratings and to substitute a standard of creditworthiness as determined appropriate by the SEC, which industry participants pointed out would render the NRSRO designations irrelevant. The letter provides that money market funds relying on the no-action letter must continue to comply with the obligations for determining and monitoring eligible securities set forth in Rule 2a-7 as in effect before May 5, 2010 (with the exception of the limitation on holding unrated asset-backed securities rescinded by the 2010 amendments to Rule 2a-7).

In addition, earlier in August 2010, in response to an ICI request for interpretation, the SEC staff agreed that, for purposes of calculating a money market fund's weighted average portfolio maturity under Rule 2a-7, a fund may treat short-term floating rate securities subject to a demand feature as having a maturity equal to the period remaining until the principal can be recovered through demand, which thereby treats these securities the same as short-term variable rate securities subject to a demand feature.

SEC Staff Issues Observations Regarding Fund Derivatives Disclosure

On July 30, 2010, SEC staff issued a letter to the ICI containing staff observations made in connection with its review of derivatives disclosure included in fund registration statements and shareholder reports. The letter provides that derivatives disclosure for certain funds may not be consistent with prospectus disclosure requirements regarding principal investment strategies and risks. The letter focused on the generic nature of funds' derivatives disclosure, noting that the disclosure ranged from briefly identifying derivative products or strategies to lengthy, technical disclosure that did not explain the relevance of the derivatives to the funds' investment operations. In particular, the letter noted that these generic disclosures generally: (1) state as a principal investment strategy that the funds will or may use derivatives and then often list all or a substantial majority of all types of derivatives as potential investments, (2) provide generic purposes for using derivatives (such as "hedging or non-hedging purposes") and (3) broadly characterize the extent to which the funds may use derivatives (such as "the fund may invest 'all' of its assets in derivatives"). The letter highlighted other issues with derivatives disclosure in fund prospectuses, including: (a) generic derivatives risk disclosure that fails to sufficiently explain the risks of the particular derivatives used by a fund, (b) the extent to which derivatives are used by a fund is not consistent with the amount of derivatives disclosure included in the fund's documents, and (c) the same derivatives disclosure is used for multiple funds in a fund complex despite the funds having significantly different exposures to derivatives.

The letter suggest that funds that use or intend to use derivatives review and assess the accuracy and completeness of their disclosure. Specifically, a fund should ensure: (1) its principal investment strategies accurately reflect the extent to which it will use derivatives, (2) its prospectus specifically describes the derivatives the fund will use, the extent to and purpose for which the fund will use derivatives and the risks of such derivatives and (3) its prospectus disclosure complies with the plain English requirement. The letter suggests that, in drafting prospectus disclosure, a fund should take into account the degree of economic exposure created by the fund's use of derivatives, as well as the amount of the fund's assets allocated to the derivatives strategy. The letter further states that a fund's prospectus risk disclosure should provide "a complete risk profile of the fund's investments taken as a whole, rather than a list of the risks of various derivative strategies, and should reflect anticipated derivatives usage."

The letter also identifies issues with derivatives disclosure in fund shareholder reports. In particular, the letter provides that Management's Discussion of Fund Performance should include derivatives disclosure commensurate with the fund's usage and should discuss any material effect a fund's use of derivatives had on the fund's performance during its most recently completed fiscal year, regardless of whether the fund is currently using derivatives. The letter also provides that a fund should disclose in its financial statements and accompanying notes how the fund used derivatives during the reporting period to meet its investment objective and strategies and the effect using derivatives had on the fund during the reporting period. The letter provides examples of how funds could improve their financial statement disclosure, including: (1) for a fund that sells credit derivatives, describing the nature of the credit derivatives, (2) for a fund that sells protection through credit default swaps, explaining the significance of the size of the credit spreads in relation to the likelihood of a credit event or the possible requirement for the fund to make payments to counterparties and (3) disclosing counterparties to forward currency and swap contracts reported in the schedule of investments. (The letter states that over-the-counter derivatives are subject to the risk of counterparty nonperformance, and therefore, the identification of the counterparty should be disclosed.)

New California Account Opening Disclosure Requirement

Effective January 11, 2011, California unclaimed property law will require all banking and financial organizations, which include registered funds, to provide a written notice to all account holders informing such person that his or her property may be transferred to the appropriate state if no activity occurs in the account within the time period specified by state law. While the notice is required under California law, such notice need not include a reference to California.

SEC Supports Sarbanes-Oxley Whistleblower Provisions for Adviser Employees

In July 2010, the SEC supported applying Sarbanes-Oxley whistleblower provisions to employees of private investment advisers to mutual funds, in its amicus brief in a case before the U.S. Court of Appeals for the Fifth Circuit in which the SEC cited another case, *Lawson v. FMR LLC* (i.e., Fidelity). Under Section 806 of the Sarbanes-Oxley Act, employees of a public company (which includes publicly offered funds) who offer reasonable evidence of federal securities law violations are protected from retaliation by any “officer, employee, contractor, subcontractor, or agent” of that company. At issue in the *Lawson* case was whether employees of various mutual funds’ private investment advisers were “covered employees” under the Sarbanes-Oxley Act. The SEC stated in its amicus brief that the *Lawson* court properly focused on the legislative history in concluding that Section 806 applied to both public companies and their private contractors, subcontractors and agents. (However, on July 28, 2010, the district court in *Lawson* ruled in favor of Fidelity to move the issue for interlocutory appeal to the U.S. Court of Appeals for review.) In the Fifth Circuit case, the question is whether Section 806 applies to a privately-held contractor of a public company where the privately-held contractor allegedly retaliated against an employee for blowing the whistle on a violation of securities law relating to the public company.

ENFORCEMENT ACTIONS

Former State Street Employees Charged by SEC for Misleading Investors About Subprime Mortgage Investments

On September 30, 2010, the SEC charged two former employees at State Street Bank and Trust Company with misleading investors about their exposure to subprime investments in State Street’s Limited Duration Bond Fund. The SEC charged State

Street in a related case earlier this year, in which the firm agreed to settle the charges by repaying fund investors more than $300 million. When the SEC announced its settlement with State Street in February, it also announced that State Street had agreed—pursuant to a limited privilege waiver—to provide information to enable the SEC to assess the potential liability of individuals involved with State Street's investor communications about the fund.

According to the order, John P. Flannery, formerly the chief investment officer, and James D. Hopkins, formerly a product engineer, played an instrumental role in drafting a series of misleading communications beginning in July 2007. The communications to investors related to the effect of the turmoil in the subprime market on the Limited Duration Bond Fund and other State Street funds that invested in it. According to the SEC, State Street provided certain investors, including State Street's internal advisory groups, with more complete information about the fund's subprime concentration and other problems with the fund.

SEC Charges Broker-Dealer for Deficient CIP Procedures

On September 1, 2010, the SEC charged Pinnacle Capital Markets LLC, a broker-dealer, with failing to comply with customer identification program ("CIP") requirements. Pinnacle's managing director, Michael A. Paciorek, was also charged with causing Pinnacle's violations. According to the order, Pinnacle established, documented and maintained a CIP that specified it would identify and verify the identities of all of its customers; however, during a six-year period, Pinnacle failed to follow the identification and verification procedures set forth in its CIP.

According to the order, many of Pinnacle's foreign institutional customers hold omnibus accounts at Pinnacle through which the entities carry sub-accounts for their own corporate or retail customers and the sub-account holders are treated in the same manner as regular account holders. Also, according to the order, Pinnacle did not verify the identities of 34 out of a sample of 55 corporate account holders from October 2003 to August 2006, and from October 2003 through November 2009, Pinnacle did not collect or verify identifying information for the vast majority of the beneficial owners of sub-accounts maintained by Pinnacle's omnibus brokerage accounts. As a result, the SEC found that Pinnacle's documented procedures differed materially from its actual procedures. Pinnacle and Mr. Paciorek agreed to settle the SEC's enforcement action without admitting or denying the allegations, and Pinnacle will pay $25,000 in penalties.

SEC Charges Former Audit Partner and Son With Insider Trading

On August 4, 2010, the SEC charged Thomas P. Flanagan, a former Deloitte & Touche LLP vice chairman and partner in the firm's Chicago office, and his son, Patrick T. Flanagan, with insider trading in the securities of several of the firm's audit clients. The SEC alleged that Thomas Flanagan had access to advance earnings results, earnings guidance, acquisition information and other nonpublic information from Deloitte's audit engagements with Best Buy, Sears and Walgreens, as well as the firm's consulting engagement with Motorola, and traded in the securities of such clients. According to the SEC, Thomas Flanagan committed insider trading nine times between 2005 and 2008 and tipped his son who then traded on the basis of the nonpublic information.

In addition to the complaint alleging insider trading, the SEC instituted administrative proceedings against Thomas Flanagan, finding that he violated the SEC's auditor independence rules on 71 occasions between 2003 and 2008 by trading in the securities of Deloitte audit clients. The SEC's settled administrative order finds that Thomas Flanagan caused and willfully aided and abetted Deloitte's violations of the SEC's auditor independence rules and Deloitte's clients' violations of the reporting and proxy provisions of the Exchange Act.

Thomas Flanagan consented to the entry of an order of permanent injunction, disgorgement with prejudgment interest of $557,158 and a penalty of $493,884, and Patrick Flanagan consented to the entry of an order of permanent injunction, disgorgement with prejudgment interest of $65,614 and a penalty of $57,656.

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