The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

Second Circuit Allows Rule 10b-5 Class Action to Proceed Against Fund Advisers

The Second Circuit Court of Appeals (Second Circuit) recently overturned the dismissal by a lower court of a class action alleging securities fraud in connection with transfer agency fees charged to certain mutual funds advised by Smith Barney Asset Management, LLC (SBAM) and Citigroup Global Markets, Inc. (CGM), which at the time were subsidiaries of Citigroup Asset Management (CAM). Following a review of the funds' transfer agency arrangements, CAM formed a subsidiary (CTB) that contracted directly with the funds to provide transfer agency services. CTB then subcontracted nearly all transfer agency services to an outside service provider, which had previously provided transfer agency services directly to the funds. Under this arrangement, the outside transfer agent provided substantially the same services as before, but at a considerably lower fee. CTB allegedly concealed certain details of this arrangement from the funds' boards of directors and continued to charge the funds for transfer agency services at the original, higher rate and retained the difference. The funds' prospectuses did not fully disclose the details of the arrangement between CTB and the service provider. The SEC conducted an investigation of SBAM and CGM in connection with this arrangement and alleged that it resulted in unnecessarily high expenses to the funds and undisclosed profits to CAM. SBAM and CGM ultimately agreed with the SEC to pay more than $200 million in fines and to disgorge the profits generated by the arrangement.

The plaintiffs claimed that CAM and its affiliates violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder (Rule 10b-5) by failing to disclose the full details of the transfer agency arrangement, including the fact that CAM was performing only negligible services and retaining the full benefit of the lower fees it had negotiated with the service provider. In dismissing the complaint, the lower court ruled that the allocation of the fees and the nominal transfer agent's profit margin are not material so long as the total amount of fees paid by the funds for various services is disclosed.

The Second Circuit noted the SEC's disclosure rules in concluding that the allocation of fees and expenses is a material fact to investors. It noted that Form N-1A requires management fees to be distinguished from 12b-1 fees and other expenses in the fee tables included in a fund's prospectus so that potential investors can compare the fees charged by different funds. By not fully disclosing the terms of the transfer agency arrangement, in the Second Circuit's view, SBAM and CGM effectively understated the funds' management fees. The Second Circuit further reasoned that this improper categorization of management fees and other expenses is material, because Section 36(b) of the Investment Company Act of 1940 imposes a fiduciary duty with respect to an investment adviser's receipt of compensation for services. The Second Circuit concluded that in 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 defendant'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."

The Second Circuit also denied the defendants' arguments that the plaintiffs cannot establish loss causation. The Second Circuit accepted the plaintiffs' argument that, even if the SEC settlement requires the defendants to disgorge all profits generated by the transfer agency arrangement, the periodic deduction of excessive transfer agency fees over time had reduced the investable assets in the funds and thereby negatively affected the market returns the funds would otherwise have achieved. Thus, the disgorgement of profits would not adequately compensate investors for the opportunity cost of the excessive fees.

Department of Labor Reproposes Investment Advice Exemptions under the Pension Protection Act

Over the past 30 years, retirement plan participation has moved from defined benefit plans that provided specified benefits to 401(k) and other individual-account plans, with substantial amounts of critical retirement assets being under the investment control of participants who are often inexperienced with investments and investment strategies.

The Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits a fiduciary of an employee benefit plan from using plan assets for the fiduciary's own account. In the context of a "401(k)" or other similar plan, this rule could impede the ability of an adviser to provide advice to plan participants, if the adviser or any of its affiliates could benefit from the investment choices of participants. Some believe that the unavailability of investment advice to many plan participants, largely resulting from ERISA's prohibited-transaction rules, has reached crisis proportions.

The Pension Protection Act of 2006 (PPA) added potentially key exemptions that would permit investment advice to be given under an eligible investment-advice arrangement without there being a prohibited transaction. One exemption permits advice to be given if certain fees are "leveled" regardless of the investment choice, and another permits advice to be given through the use of a qualified computer model.

The US Department of Labor (DOL) had issued regulations that would have implemented the new exemptions, including an additional fee-leveling class exemption that, with the imposition of a number of additional conditions, would have gone beyond the statutory exemption in allowing advice to be given. Amid a firestorm of political objection, and in connection with the change in presidential administrations, the regulations were withdrawn in their entirety.

The DOL has now reproposed its regulations under the PPA's investment advice exemptions. The reproposal drops the previously adopted (and withdrawn) fee-leveling class exemption. Otherwise, the new proposed regulations would largely reinstate the previously withdrawn regulations. The regulations, if re-finalized, could permit a broad array of advice to be provided that is not presently available, particularly under the fee-leveling exemption, and could be extremely significant to plan participants and to advisers wishing to provide advice to plan participants.

Southern District of New York Dismisses Class Action Against Mutual Fund, Adviser and Trustees Related to Fund's Subprime Investments

The United States District Court for the Southern District of New York recently dismissed with prejudice a securities class action complaint alleging prospectus violations against the SSgA Funds, a mutual fund complex managed by a subsidiary of State Street Corporation. The complaint alleged violations of sections 11, 12(a)(2), and 15 of the Securities Act of 1933 based upon the prospectus disclosures of the SSgA Yield Plus Fund (Fund) regarding its investment in mortgage-related securities. In particular, the plaintiff asserted that the Fund's offering documents misled investors regarding the nature and extent of the Fund's investments in subprime mortgage-related securities in three ways: (1) by stating that the Fund invested in "high-quality" securities when the Fund actually invested in "risky mortgage-related instruments;" (2) by masking the extent of the Fund's mortgage-related holdings by classifying certain securities as Asset-Backed Securities (ABS) rather than Mortgage-Backed Securities (MBS) in shareholder reports; and (3) by misstating the value of the Fund's mortgage-related securities, which led to overstatements of the Fund's net asset value. Finding that the plaintiff had failed to plead any actionable misrepresentations, the Court dismissed the complaint, refusing to grant the plaintiff leave to amend the complaint.

In dismissing the complaint, the Court first held that the prospectus disclosure describing the portfolio as consisting of "high-quality" securities was not an actionable misrepresentation. Because 80% of the Fund's holdings were rated either "AAA" or "AA," and all holdings were rated at least "A," the portfolio holdings were consistent with the "high-quality" description. The Court explained that while, in hindsight, those bonds did not necessarily live up to the ratings assigned to them, the accuracy of offering documents must be assessed in light of information available at the

time the documents were published. The Court also rejected plaintiff's argument that SSgA should have disclosed to investors the dire state of the mortgage market and its potential impact on the Fund, stating that investors are imputed with knowledge of public information regarding market trends.

Second, the Court held that the offering documents and shareholder reports did not misrepresent the extent of the Fund's investment in MBS by categorizing some of the Fund's mortgage-related securities as ABS. According to the Court, the sheer number of obviously mortgage-related securities under the ABS category should have put a reasonable investor on notice that the MBS category did not constitute the entirety of the Fund's mortgage-related exposure.

Finally, the court rejected the plaintiff's allegation that the Fund misstated the value of its mortgage-related holdings, resulting in an overstated net asset value, because the complaint failed to allege that State Street violated its disclosed valuation procedures. The Court recognized that "[t]here is no single, objectively acceptable method for valuing" mortgage-related instruments, but that the Fund's offering documents clearly set forth the Fund's valuation procedures. Accordingly, the Court held that there was no misrepresentation where the stated valuations complied with the disclosed methods. The Court noted that "the simple fact of a write-down does not stand for the proposition that values stated before the write-down were inaccurate."

Ropes & Gray represents State Street and the Fund in this action.

Amendments to Rules Requiring Internet Availability of Proxy Materials

On February 22, 2010, the SEC amended the rules under the Securities Exchange Act of 1934 (the Exchange Act) regarding internet availability of proxy materials. The rule amendments are effective March 29, 2010. The amendments are designed to remove impediments that may be reducing shareholder response rates to proxy solicitations. Rule 14a-16 under the Exchange Act currently requires a soliciting person to provide security holders with a Notice of Internet Availability of Proxy Materials (Notice) that includes the specific legend provided in the rule. The amendment aims to provide soliciting persons additional flexibility in formatting and selecting the language to be used in the Notice rather than requiring the use of a "boilerplate" legend. The final rule requires that the Notice address certain topics, rather than specifying the exact language to be used. The final rule also allows the soliciting person to include with the notice an explanation of the process for receiving and reviewing proxy materials and an explanation of the reasons for the use of the "notice and access" rules. The SEC also confirmed its guidance in the proposing release that the Notice need not mirror the proxy card.

Additionally, the SEC amended Rule 14a-16(l)(2) under the Exchange Act, which currently requires soliciting persons other than the issuer to send the Notice to shareholders within ten calendar days after the date that the issuer first sends its proxy materials to shareholders. The practical effect of this requirement was to limit a soliciting person's ability to use the notice-only option (in lieu of delivering a full set of proxy materials) if the soliciting person was unable to file its definitive proxy statement by that time. The amended rule requires soliciting persons other than the issuer to file a preliminary proxy statement within ten calendar days after the issuer files its definitive proxy statement and to send the Notice to shareholders no later than the date on which it files its definitive proxy statement. The intended effect of this amendment is to provide sufficient time for a soliciting person who intends to use the notice-only option to prepare a proxy statement and to respond to any SEC comments. Finally, the SEC amended Rule 14a-16(f)(2)(iii) under the Exchange Act to allow a fund to accompany the Notice with a summary prospectus.

Third-Party Verification of Advisers' Records Now Routinely Requested by SEC

In the wake of the Madoff scandal SEC examiners have been routinely requesting verification of the information contained in the records of investment advisers from third parties, such as customers, services providers or counterparties. The SEC recently published the form of request letter being sent to customers. This letter states that

"This request for information is voluntary and you are not required to provide information in response to this letter." The SEC letter also encloses a copy of SEC Form 1662 entitled, "Supplemental Information for Registered Entities Directed to Supply Information Other Than Pursuant to a Commission Subpoena." This somewhat intimidating form explains, among other items, the penalties for supplying false information.

Arbitration Clause in Investment Advisory Agreement Upheld

In *Bakas v. Ameriprise Financial Services, Inc.*, 651 F. Supp. 997 (D. Minn. 2009), the United States District Court for the District of Minnesota upheld an arbitration clause in an investment services agreement. Under this agreement Ameriprise, an SEC registered investment adviser, was required to provide the client with certain financial planning services, including a written financial plan aligned with each client's goals and needs. The investment services agreements contained mandatory arbitration clauses and provisions that prohibited the client from maintaining claims against Ameriprise on a class basis. An investor, who had executed several investment services agreements, filed a class action lawsuit against the adviser alleging several causes of action under the Investment Advisers Act of 1940 and state law. The adviser moved to compel arbitration or, alternatively, to dismiss the action.

The investor advanced several arguments in support of the invalidity of the arbitration clause, including the following: (1) Financial Industry Regulatory Authority (FINRA) rules prohibit enforcement of arbitration of putative class action claims because the adviser is also a registered broker-dealer; (2) the position of the staff of the Securities and Exchange Commission in denying no-action relief in *McEldowney Financial Services* (October 17, 1986) that the Investment Advisers Act of 1940 affords certain non-waivable rights of action, including "the right to choose the forum, whether arbitration or adjudication, in which to seek resolution of disputes"; and (3) the arbitration clause precluded the investor from seeking equitable or injunctive relief because no arbitrator can grant such relief. The Court rejected the investor's arguments on several grounds, including that the FINRA rules did not apply to the adviser because it was not acting as a broker-dealer in providing the investor with investment advice, *McEldowney Financial Services* did not preclude compulsory arbitration of the investor's claims because the court decision it was based on, *Wilko v. Swan,* has since been overruled, and the rules of the American Arbitration Association in fact permit equitable relief.

Other Developments

Since the last issue of our IM Update we have also published the following separate Client Alerts of interest to the investment management industry:

Potential Effects on Funds and Investment Advisers of The Wall Street Reform and Consumer Protection Act of 2009–January 11, 2010

SEC Adopts Final Amendments to the Custody Rule under the Advisers Act–January 12, 2010

Hedge Fund Update–February 23, 2010

Government Issues Long-Awaited Guidance on FBARs–March 1, 2010

SEC Adopts Money Market Reforms–March 3, 2010

SEC Amends Regulation SHO to Impose a Circuit Breaker/Price Test Restriction on Short Sales - March 4, 2010

For further information, please contact the Ropes & Gray attorney who normally advises you.