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

Court Rules that Change in Fund's Industry Classifications Requires Shareholder Approval

The United States District Court in the Northern District of California issued an order in the case of *In re Charles Schwab Securities Litigation*, granting summary judgment in favor of the plaintiffs based on the court's interpretation of Sections 8(b)(3) and 13(a)(3) of the Investment Company Act of 1940 (1940 Act). Under Section 8(b)(3), a fund must include in its registration statement any fundamental policy (including an industry-concentration policy) of the fund, and under Section 13(a)(3), a fund may not deviate from its concentration policy (or any other fundamental policy) without first obtaining shareholder approval. The fund involved in the case had a fundamental policy not to concentrate its investments in any one industry. The fund disclosed in 2001 that it would treat non-agency mortgage-backed securities (MBS) as a separate industry for purposes of its concentration policy. This policy regarding how the fund would classify MBS was identified in the fund's statement of additional information (SAI) as a non-fundamental policy that could be changed without shareholder approval. In 2005, the fund amended its registration statement to disclose that it would not treat MBS as being part of any industry for purposes of the fund's concentration policy. This change in industry classification was made without obtaining a shareholder vote.

The ICI filed an amicus brief in the case, arguing that under Sections 8(b)(3) and 13(a)(3) of the 1940 Act, a fund's industry concentration policy is separate and distinct from the industry classifications that it uses to implement the policy. The ICI brief states that, although the actual concentration policy may not be changed without shareholder approval, this does not limit a board of trustees' ability to make changes to industry classifications without a shareholder vote. The ICI further notes that, because the investment management industry evolves rapidly and continually, preserving board discretion to change a fund's industry classifications to adapt to these changes is in a shareholder's best interests.

The SEC also filed an amicus brief in which it took an opposing view. The SEC argued that the fund's concentration policy and industry classifications were two components of the fundamental policy included in the fund's SAI. According to the SEC, the fund's concentration policy and its industry classifications must be read together, and shareholder approval should be obtained when a fund changes from previously-stated industry classifications.

In its decision, the court characterized the change in the industry classification of MBS as a unilateral decision by the fund's sponsor to "reverse its field" as to the fund's investment strategy. In the court's view, the fund sponsor could not make this change on its own, after having "attracted many millions to the fund" by telling investors that it would pursue what the court characterized as a a different investment strategy. The court reasoned that since a shareholder vote would have been required to change the fund's fundamental policy with regard to industry concentration, a different result should not be permitted where a fund changed the definition of what was already an identifiable industry. According to the court, the change in the classification of MBS was not the "mere clarification of an otherwise blurred line." Rather it was an "entire repudiation of a clear-cut definition that had become a fixture of the fund."

Privacy and Data Security Updates

Regulation S-AM. June 1, 2010 is the compliance date for Regulation S-AM, which limits the ability of brokers, dealers, investment companies, registered investment advisers, and registered transfer agents to

send marketing solicitations to consumers based on consumer creditworthiness information (eligibility information) shared by affiliates without first providing to the consumer notice and the opportunity to opt-out from those marketing solicitations.

Form S-P–Model Privacy Form. Financial institutions can now use the model privacy form—Form S-P—as a safe harbor to comply with the notice, disclosure, and opt-out requirements under Regulation S-P. Use of Form S-P is voluntary. Form S-P can also be used to comply with the notice, content, and opt-out requirements under Regulation S-AM, provided that certain specific conditions are met. In preparing Form S-P, you may utilize the online automated form builder by clicking here.

Red Flag Rules. On June 1, 2010, the Federal Trade Commission will begin to enforce the "Red Flag Rules" that require financial institutions or creditors—which are defined broadly to include businesses that hold consumer accounts allowing for payments or transfers to third parties or that regularly defer consumer payments for goods or services—to develop procedures for detecting, preventing, and mitigating identity theft in connection with covered accounts.

Enforcement Action. Recently FINRA fined a broker-dealer $375,000 for violations of Regulation S-P and FINRA Rules for having inadequate safeguards to protect the security and confidentiality of customer information, after an international criminal group infiltrated the broker-dealer's database and gained access to the confidential information of approximately 230,000 of the broker-dealer's customers.[1] Although this enforcement action was brought by FINRA against a broker-dealer, similar proceedings may be (and have been) brought against investment companies and registered investment advisers pursuant to Rule 30 of Regulation S-P (the Safeguards Rule), which requires that every broker, dealer, investment company, and registered investment adviser adopt policies and procedures designed to protect customer information. The current Safeguards Rule does not yet provide specific safeguarding requirements, although the SEC proposed amendments to the Safeguards Rule in 2008 to address this. Regardless of the Safeguards Rule's lack of specificity, if a breach of customer information occurs, regulators are likely to scrutinize an entity's current security framework and make an after-the-fact determination of its effectiveness. Therefore, investment managers should regularly review their safeguard policies and procedures to ensure that they appropriately address current threats to customer confidential information.

SEC Staff to Review Collective Investment Trusts' Exemption

Buddy Donohue, Director of the Division of Investment Management, in a recent speech signaled that the SEC Staff is considering whether reliance on the exemption from registration under Section 3(c)(3) of the 1940 Act by certain collective investment trusts remains appropriate. Mr. Donohue said that one of the underlying reasons for permitting collective investment trusts to be exempt from registration is that a bank, which is subject to supervision by bank regulatory authorities, will be the entity that makes the investment management decisions over the pooled assets. He said the Staff will consider whether the exemption is properly relied upon and consistent with the 1940 Act, where, for example, banks may be acting merely in a custodial or similar administrative capacity with regard to a collective investment trust.

SEC Proposes Changes to Asset Backed Securities Regulations

On April 7, 2010, the SEC released a proposed revision to Regulation AB and related rules to address a perceived widespread lack of understanding about asset-backed securities among investors as well as a lack of access to information about the underlying assets.[2] The proposal focuses on three main areas: creating new registration procedures, including new shelf eligibility requirements; providing for new disclosure, including asset-level information; and establishing new information requirements for the safe harbors under Rule 144A and Regulation D.

[1] D.A. Davidson & Co. (CRD # 199) (April, 9 2010), available at http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p121260.pdf.

[2] Asset-Backed Securities, Securities Act Release No. 33-9117 and Exchange Act Release No. 34-61858 (Apr. 7, 2010).

Among the proposals is a requirement that prospectuses used for public offerings of asset-backed securities and ongoing Exchange Act reports contain disclosure of standardized *asset-level* information. For example, issuers would be required to disclose information about the payment stream for each asset as well as the quality of the obligor or the asset origination process. Among other things, issuers would also be required to file a waterfall computer program in a downloadable open-source code at the time of the offering and periodically thereafter so that investors may input their own assumptions about cash flow and view the various outcomes generated, rather than relying on computer programs not accessible to all investors or credit rating information.

Recent Anti-Money Laundering Developments

Recent joint guidance from SEC, FinCEN, and other agencies may impact how mutual funds are required to obtain and retain beneficial ownership information for anti-money laundering (AML). As part of a financial institution's AML compliance program, an institution should establish and maintain customer due diligence (CDD) 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 provides some examples of procedures that CDD processes may include, such as (i) determining whether the customer is acting as an agent for or on behalf of another, (ii) where the customer is a legal entity that is not publicly traded in the U.S. (including unincorporated associations, private investment companies, trusts or foundations), obtaining information about the structure or ownership of the entity; and (iii) where the customer is a trustee, obtaining information about the trust structure so the institution can have a reasonable understanding of the trust structure and determine the provider of the funds and any persons or entities that have control over the funds or have the power to remove the trustees.

The guidance makes clear that existing Customer Identification Program (CIP) requirements, which require a fund to verify the identity of a new investor, are not affected by the new guidance. However, there are a number of unanswered questions regarding various aspects of the guidance, including the definition of "beneficial ownership" in various contexts, when CDD should be performed if it is not required as part of CIP, whether and when CDD must be performed on existing investors, and how the guidance should be implemented in light of the fact that many funds rely on their transfer agents to perform monitoring duties under an anti-money laundering program (*e.g.*, which party performs the subjective risk assessments described in the release). To date, there has been no further regulatory guidance, and no established industry practice has developed with respect to these issues.

The Financial Crimes Enforcement Network (FinCEN) has amended the rules implementing the Bank Secrecy Act (BSA) such that open-end investment companies are now considered "financial institutions" within the meaning of 31 CFR § 103.11. This has the effect of requiring that (i) mutual funds report certain transactions involving more than $10,000 in currency on Currency Transaction Reports (CTRs; FinCEN Form 104) rather than on Form 8300 and (ii) mutual funds comply with the recordkeeping and travel rule requirements under the BSA regulations (the travel rule), which require the creation and retention of certain records and the transmission of certain information with transmittals of funds (*e.g.*, wire transfers) exceeding $3,000, subject to certain exceptions. The FinCEN rule amendments also (i) clarify that FinCEN has delegated examination authority with respect to mutual fund BSA compliance to the Securities and Exchange Commission rather than the Internal Revenue Service and (ii) subject mutual funds to record creation and retention requirements under 31 CFR § 103.33 related to the extension of credit and cross-border transfers of currency, monetary instruments, checks, investments securities, and "credit in" transactions of greater than $10,000 (103.33 recordkeeping), which (as stated in the release) is expected to have a "*de minimus* impact" on mutual funds and their transfer agents in light of existing applicable recordkeeping requirements. The CTR requirement will apply to mutual funds beginning May 14, 2010 and the travel rule and 103.33 recordkeeping requirements will apply to mutual funds beginning January 10, 2011.

If a mutual fund acts for a transmittor or recipient who is not an established customer, the mutual fund would be required to comply with the travel rule's customer verification requirements. The travel rule also contains requirements related to the retrievability of records created under the rule. Mutual fund administrators should work closely with compliance personnel, transfer agents, custodians and/or other service providers, as necessary, to evaluate the impact the travel rule will have and to determine whether service provider agreements need to be amended to delegate these new compliance functions.

FINRA Fines Member For Failure to Obtain E-mail Records

A broker-dealer was recently censured and fined $100,000 by FINRA for failing to maintain custody or control over records of business-related electronic communications sent or received by its representatives employed at the firm's investment adviser clients. Apparently the broker dealer relied on the investment advisers to keep such records, but was not able to easily access them without first requesting them from, and having such records subject to review by, each investment adviser client. This arrangement was found not to comply with FINRA rules, which require that such records be "easily accessible" by the FINRA member.

Other Developments

Since the last issue of our *IM Update* we have also published the following separate Client Alert(s) of interest to the investment management industry:

- Supreme Court Decides Jones v. Harris Associates and Establishes Standard for Mutual Fund Excessive Fee Claims–March 30, 2010
- Hedge Fund Update–April 14, 2010
- SEC Proposes Large Trader Reporting System–May 3, 2010

We have also hosted the following teleconferences which can be made available for replay.

- Teleconference: Jones v. Harris—What the Victory Really Means–April 1, 2010
- Hedge Funds and ERISA–Hot Topics and Current Issues–April 27, 2010
- Investment Management M&A: Preparing for Opportunities in a Recovering Market–May 4, 2010

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