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DEVELOPMENTS OF NOTE

SEC Commences Administrative Proceedings over Pricing of Securities Backed by Subprime Mortgages in Mutual Fund and Closed-End Fund Portfolios as FINRA and State Authorities Take Related Action

The SEC issued an order (the "SEC Order") commencing administrative proceedings against a registered investment adviser (the "Adviser"), a registered broker-dealer affiliate of the Adviser (the "Distributor"), the Adviser's portfolio manager (the "Portfolio Manager") for seven affiliated bond funds sponsored by the Adviser (the "Funds"), and the Distributor's Controller and Head of Fund Accounting (the "Controller"). The SEC Order alleges that during the period between January 2007 and July 2007 (the "Relevant Period") the daily net asset value ("NAV") of each of the Funds, which consist of three open-end funds and four closed-end funds, was materially inflated as a result of fraudulent conduct relating to the pricing of securities backed by subprime mortgages ("Asset Backed Securities") on the part of the Adviser, the Distributor, the Portfolio Manager and the Controller (collectively, the "SEC Respondents"). This article summarizes the SEC's allegations as included in the SEC Order. The SEC Respondents have not yet filed an answer to the SEC Order nor has there yet been any finding with respect to the SEC's allegations.

Background. During the Relevant Period, the Adviser served as the investment adviser to each of the Funds; the Distributor served as the principal underwriter and exclusive distributor for the Funds' shares and provided certain accounting services, including

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valuation services, to the Funds; the Portfolio Manager served as the portfolio manager of the Funds; and the Controller, in his capacity as Head of the Distributor's Fund Accounting Department ("Fund Accounting"), was responsible for oversight of the pricing of the Funds' securities and calculating of the Funds' daily NAV. Each of the Funds pursued its investment objectives in part by investing, in varying amounts, in Asset Backed Securities, which lacked readily available market quotations and in accordance with Section 2(a)(41)(B) of the Investment Company Act were required to be priced in accordance with their fair value. The Funds' Boards of Directors (collectively, the "Board") established pricing policies and procedures (the "Valuation Procedures") which, among other things, delegated daily pricing of the Funds' securities to the Distributor under the terms of an accounting services arrangement and required that fair valued securities would be valued in "good faith" by a Valuation Committee, which was comprised of the Controller and other the Distributor personnel. Further, the Valuation Procedures required that dealer quotes be obtained by the Distributor for certain securities that were to be fair valued, including the Asset Backed Securities.

Acting Contrary to Public Disclosures. During the Relevant Period, the Distributor did not price the Funds' securities in accordance with the Valuation Procedures and the valuation process set forth in the Funds' documents filed with the SEC (the "SEC Documents"), including each Fund's prospectus, differed significantly from the process described in the Valuation Procedures. The SEC Documents stated that the fair value of securities would be determined by the Adviser's valuation committee using procedures adopted by the Funds; however, this responsibility was delegated to the Distributor, which primarily staffed the Valuation Committee. The Distributor and the Valuation Committee failed to comply with the Valuation Procedures in several ways, including: (1) pricing decisions were made by lower level employees in the Distributor's Fund Accounting Department ("Fund Accounting") who did not have the training or qualifications to make fair value pricing determinations; (ii) Fund Accounting relied on "price adjustments" provided by the Portfolio Manager without obtaining any basis for or documentation supporting the price adjustments or applying the factors set forth in the Valuation Procedures; (iii) the Distributor gave the Portfolio Manager excessive discretion in validating the prices of portfolio securities by allowing him to determine which dealer quotes to use, without obtaining supporting documentation; and (iv) neither the Valuation Committee nor the Distributor ensured that the fair value prices assigned to many of the portfolio securities were periodically re-evaluated, allowing them to be carried at stale values for many months at a time. Further, the Adviser adopted its own procedures to determine the actual fair value of portfolio securities and to "validate" those values "periodically." Among other things, those procedures provided that "[q]uarterly reports listing all securities held by the Funds that were fair valued during the quarter under review, along with explanatory notes for the fair values assigned to the securities, shall be presented to the Board for its review." The Adviser failed to fully implement this provision of its policy. The Portfolio Manager was aware that the "price adjustments" he provided, which in many cases were arbitrary and did not reflect fair value, were used to compute the Funds' NAVs.

Moreover, the Controller either knew or was highly reckless in not knowing, of the deficiencies in the implementation of the Valuation Procedures and did nothing to remedy them or otherwise to make sure fair-valued securities were accurately priced and the Funds' NAVs were accurately calculated. Among other things, the Controller was aware of each of the deviations from the Valuation Procedures set forth above, and that the only pricing test regularly applied by the Valuation Committee was the "look back" test, which compared the sales price of any security sold by a Fund to the valuation of that security used in the

NAV calculation for the five business days preceding the sale. The Controller nevertheless signed the Funds' annual and semi-annual financial reports on Forms N-CSR, filed with the SEC, including certifications pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002.

On this basis, the SEC Order alleges that the Distributor failed to employ reasonable procedures to price the Funds' portfolio securities and, as a result of that failure, did not calculate accurate NAVs for the Funds. In addition, the Distributor recklessly published daily NAVs for the Funds which it could not know were accurate and sold shares to investors based on those NAVs.

Fraudulent Manipulation of the Funds' Securities Prices. The Portfolio Manager fraudulently manipulated the dealer quotes received during the Relevant Period from at least one broker-dealer (the "Submitting Firm") by pressuring the Submitting Firm to in certain cases to (1) refrain from providing dealer quotes that reflected actual bid prices, and (2) provide interim quotes that did not reflect fair value to enable the Portfolio Manager to avoid marking down securities to fair value in one adjustment. In each case the Portfolio Manager was aware that the securities in question would ultimately be required to be marked down over time. The Portfolio Manager did not disclose to Fund Accounting or the Funds' Boards that he had received quotes from the Submitting Firm which were lower than the current valuations recorded by the Funds, and that the Submitting Firm had refrained from submitting quotes to Fund Accounting or had submitted quotes at higher prices than it had originally planned. The Portfolio Manager also did not disclose that he caused the Submitting Firm to alter or withhold quotes. Additionally, in certain instances the Portfolio Manager provided "price adjustments" for securities that were above the dealer quote received from the Submitting Firm in violation of the Valuation Procedures. The SEC Order also alleges that in at least one instance during the Relevant Period the Portfolio Manager withheld material information regarding a substantial decrease in value of an Asset Backed Security held in the Funds from Fund Accounting in breach of his fiduciary duty as portfolio manager of the Funds.

Misrepresentations to Investors and the Board. By including a signed letter to investors reporting on the Funds' performance "based on net asset value" in each of the Funds' annual and semi-annual reports filed with the SEC on Forms N-CSR during the Relevant Period, the Portfolio Manager made fraudulent misrepresentations to and omissions of material fact directly to the Funds' investors concerning the Funds' performance. By virtue of the Portfolio Manager's manipulation of the NAV of the Funds' and the valuation of certain securities the Portfolio Manager, and through him the Adviser, was aware that the performance of the Funds was materially misstated. Additionally, the Adviser, through the Portfolio Manager, also defrauded the Funds by providing a quarterly valuation packet reflecting inflated prices for certain securities to the Board, failing to disclose to the Board information indicating that the Funds' NAVs were inflated, and that the Portfolio Manager was actively screening and manipulating dealer quotes and providing Fund Accounting with unsubstantiated price adjustments. In addition, the SEC Documents described the Adviser as responsible for fair valuation of the Funds' portfolios; however, as noted above the Distributor was actually performing the valuation services for the Funds.

Violations. As a result of the conduct described above, the SEC Order alleges violations of the following provisions of the federal securities laws by various of the SEC Respondents:

- Section 17(a) of the Securities Act; Section 10(b) of the Exchange Act and Rule 10b-5, thereunder (which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities);
- Section 206(4) of the Advisers Act and Rule 206(4) 7 thereunder (which prohibit fraudulent, deceptive or manipulative practices or courses of business by an investment adviser, and requires investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and the rules thereunder by their supervised persons, respectively)
- Sections 206(1) and 206(2) of the Advisers Act (which prohibit fraudulent conduct by an investment adviser);
- Section 34(b) of the Investment Company Act (which prohibits untrue statements of material fact or omissions to state facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, in any registration statement, report or other document filed pursuant to the Investment Company Act or the keeping of which is required pursuant to Section 31(a) of the Investment Company Act)
- Rule 22c-1 promulgated under the Investment Company Act, (which makes it unlawful for an open-end fund to sell, redeem, or repurchase such securities except at prices based on current net asset value); and
- Rule 38a-1 promulgated under the Investment Company Act, (which requires that a registered investment company adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including policies and procedures that provide for oversight of compliance by the investment company's investment adviser).

Possible Sanctions. Among the possible sanctions contemplated by the SEC Order are civil penalties, disgorgement and censure.

Related Proceedings - FINRA

In a proceeding based on related factual allegations, the Financial Industry Regulatory Authority ("FINRA") issued a complaint against the Distributor (the "FINRA Complaint") alleging that during the Relevant Period, the Distributor sold the Funds using false and misleading materials in violation of NASD Rules 2110, 2210 and 3010. The Distributor is a broker-dealer registered with the SEC and a member of FINRA. During the Relevant Period the Distributor served as the principal underwriter of the Funds, exclusive distributor for the Funds' shares and provided certain accounting services, including valuation services, to the Funds.

The FINRA Complaint alleges that during the Relevant Period, (1) the Funds were heavily invested in risky structured products, including Asset Backed Securities, and that these investments caused the Funds to experience serious financial difficulties beginning in early 2007, (2) misleading sales materials, combined with the Distributor's misleading and deficient internal guidance and failure to train its brokers about the risks associated with the Funds, led the Distributor's brokers to make material misrepresentations to investors regarding the Funds, and particularly with respect to one of the Funds (the "Intermediate

Fund”), which was marketed as a relatively safe and conservative fixed income mutual fund investment when, in fact, it was exposed to undisclosed risks associated with its investment in Asset-Backed Securities and subordinated tranches of other structured products, (3) despite the negative impact on the Funds in early 2007 resulting from the turmoil in the mortgage-backed securities market the Distributor failed to disclose in any of its 2007 sales material that a substantial portion of the Funds' portfolios were acutely affected by then-current economic conditions, and (4) the Distributor failed to establish, maintain and enforce an adequate supervisory system, including written supervisory procedures, reasonably designed to achieve compliance with federal securities laws and FINRA rules.

Specifically, the FINRA noted that (1) in its research, investment advice and performance updates related to the Intermediate Fund, the Distributor failed to disclose the material characteristics and risks of investing in the Intermediate Fund, misstated the appropriate use of the Intermediate Fund and otherwise portrayed the Intermediate Fund as a safer investment than it was, even though the Distributor was aware of material, special risks that made the Intermediate Fund unsuitable for many retail investors; (2) the Distributor failed to ensure the accuracy of the advertising materials prepared by the Adviser and distributed by the Distributor, and failed to ensure that those materials disclosed all material risks, were not misleading and did not contain exaggerated claims; (3) the Distributor failed to train its brokers regarding the features, risks and suitability of the Funds; and (4) when the Distributor became aware of the adverse market effects on the Funds, the Distributor failed to timely warn its brokers or revise its advertising materials to reflect the disproportionately adverse effect the market was having on the performance of the securities that comprised the Funds.

As a result of the foregoing conduct, the FINRA Complaint requests that one or more of the sanctions provided under FINRA Rule 8310(a), including monetary sanctions, be imposed, including that the Distributor be required to disgorge fully any and all ill-gotten gains and/or make full and complete restitution, together with interest and/or offer rescission to Fund purchasers, and that the Distributor bear such costs of proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330.

Related Proceedings - States

In a related proceeding based on factual allegations similar to those contained in the FINRA Complaint, the state securities regulators of the states of Alabama, Kentucky, Mississippi and South Carolina (collectively, the “States”) have issued a Joint Notice of Intent to Revoke Registration and Impose Administrative Penalty (the “Joint Notice”) against the Adviser and the Distributor for violating the corresponding provisions of the securities act of each of the States (the “State Securities Acts”). In addition to being registered with the SEC as a broker-dealer and being a member of FINRA, the Distributor is registered as a broker-dealer with each of the States. The Adviser is registered as an investment adviser with the SEC and makes notice filings, but is not registered, with the States.

Specifically, the Joint Notice alleges that during the Relevant Period each of the Adviser and the Distributor violated the relevant provisions of the State Securities Acts by: (1) making material omissions and misrepresentations in marketing materials related to the Funds, (2) making material omissions and misrepresentations in the SEC Documents, (3) withholding information from and misrepresenting information concerning the Funds to the brokers selling the Funds, (4) providing preferential treatment to certain customers, (5) failing to make suitable recommendations concerning purchase and concentration of the

Funds in customer accounts, (6) failing to adequately supervise their employees, and (7) failing to adequately respond to due diligence requests from the division of the Distributor responsible for oversight and implementation of asset allocation products that in part used the Funds as underlying investment options.

In connection with the Joint Notice each of the States is seeking restitution of investor losses in the amount of \$2 billion, imposition of administrative penalties, reimbursement of investigative costs, revocation of the registration of the Distributor, and to bar each of the Adviser and the Distributor from further participation in the securities industry in the respective States. Additionally, each of the States is seeking to revoke the registration of, and to bar from further participation in the securities industry of, certain individuals, including the Portfolio Manager, the President and Chief Executive Officer of the Adviser, and the Chief Compliance Officer of the Funds and the Adviser.

FDIC Proposes Risk-Sensitive Deposit Insurance Assessment Scheme for Large and Highly Complex Institutions

I. Introduction

The FDIC issued a Notice of Proposed Rulemaking (the “Proposal”) to revise the deposit insurance assessment system for large institutions and for highly complex institutions. The Proposal is an effort by the FDIC to develop an assessment methodology that is more responsive to risks taken on by insured institutions and is less pro-cyclical than the current assessment system. Therefore, the Proposal replaces the financial ratios used in the current assessment system with a scorecard consisting of risk-sensitive financial measures and eliminates the use of credit ratings. The financial measures would be calculated based on inputs taken from institutions’ Call or TFR reports, the FDIC’s Large Insured Depository Institution (“LIDI”) program, and examination results. The Proposal also would alter the assessment rates applicable to all insured depository institutions to ensure that the revenue collected under the proposed assessment system would approximately equal the revenue collected under the existing assessment system and to maintain parity among large and small institutions. The Proposal is very detailed, and, if promulgated, would represent a significant increase in the complexity of calculating and managing deposit insurance assessments for large and highly complex institutions, in some respects matching the complexity of calculating risk-based capital measures. However, the FDIC does not believe that the Proposal, if promulgated, will significantly affect the amount of assessments collected overall.

II. Large Institution Scorecard and Base Assessment Rate

The Proposal calculates the assessment rate for large institutions using a scorecard which is based on institution performance and financial measures as potentially modified by discretionary and liability-based adjustments available to the FDIC. A “large institution” would be defined under the Proposal as an insured depository institution with \$10 billion or greater in total assets for at least four consecutive quarters. Insured branches of foreign banks would not be defined as large institutions. The scorecard would have two components, a performance score (the “Performance Score”) and loss severity score (the “Loss Severity Score”). Each score is subject to discretionary adjustments by the FDIC. The two component scores would then be combined, using a mathematical formula, to produce a total score, which would be translated into an initial assessment rate, which

would in turn be converted into a total assessment rate based on the FDIC's liability-based adjustments if applicable.

a. Performance Score

An institution's performance score is a weighted average of three inputs, which are described in more detail below.

(i) Weighted Average CAMELS Score

A weighted average of an institution's CAMELS score constitutes 30% of such institution's Performance Score. Due to a non-linear conversion, the Performance Score would increase at an increasing rate as the weighted average CAMELS rating increases. The Proposal clarifies that if the FDIC disagrees with the ratings changes to an institution's risk assignment by its primary federal regulator or, for state-chartered institutions, by the state banking supervisor, the FDIC will notify the institution of its decision and any resulting change to an institution's risk assessment is effective as of the date of FDIC's transmittal notice.

(ii) Asset-Related Stress Component

The ability of an institution to withstand asset-related stress constitutes 50% of such institution's Performance Score and is based on a weighted calculation combining the following financial measures:

- Tier 1 common capital ratio;
- Concentration measure (the higher, or least favorable, of the higher-risk concentrations measure or growth-adjusted portfolio concentrations measures);
- Core earnings/average total assets;
- Credit quality measure (the higher, or least favorable, of the criticized and classified items/Tier 1 capital and reserves or underperforming assets/Tier 1 capital and reserves)

Each of these measures is described in detail in Appendix B to the Proposal. Each of the measures is also subject to a minimum and a maximum cutoff, meaning that to the extent that such measures produce values that are very low or very high, the effect of such value on the Performance Score is limited. However, in order to deal with outliers, the FDIC would increase the performance score significantly if either or both of the credit quality measure or the higher risk concentration measure were to exceed certain stated values. Such adjustment measures are referred to as "outlier add-ons."

(iii) Funding-Related Stress Component

The ability of an institution to withstand funding-related stress constitutes 20% of such institution's Performance Score and is based on a weighted calculation combining the following financial measures:

- Core deposits to total liabilities ratio

- Unfunded commitments to total assets ratio
- Liquid assets to short-term liabilities (liquidity coverage) ratio

Each of these measures is described in detail in Appendix B to the Proposal. Each of the measures is also subject to a minimum and a maximum cutoff, meaning that to the extent that such measures produce values that are very low or very high, the effect of such value on the Performance Score is limited.

(iv) Discretionary Adjustment

The Performance Score could be significantly adjusted, in the discretion of the FDIC, up or down, based upon significant risk factors that are not adequately captured in the performance scorecard. The resulting score, however, cannot be lower than a certain minimum nor higher than a certain maximum. Appendix E to the proposal lists some, but not all, criteria that could be considered in determining whether or not a discretionary adjustment is appropriate. In general, the proposed adjustments would have a proportionally greater effect on the assessment rate of those institutions with an otherwise higher assessment. Notifications involving an upward adjustment to an institution's assessment rate would be made in advance of implementing such an adjustment so that the institution has an opportunity to respond to or address the FDIC's rationale for proposing an upward adjustment. Adjustments would be implemented after considering the institution's response to the notification along with any subsequent changes either to the inputs or other risk factors that relate to the FDIC's decision.

b. Loss Severity Score

The Loss Severity Score would measure the relative magnitude of potential losses to the FDIC in the event of an institution's failure, and is based on a calculation that equally weighs two measures: the loss severity measure, and the secured liabilities measure. (Appendix D to the Proposal describes the calculation of the loss severity measure in detail, while Appendix B defines the component measures and gives the sources of the data used to calculate them.) The loss severity measure is the ratio of possible losses to the FDIC in the event of an institution's failure to total domestic deposits, averaged over three quarters. A standardized set of assumptions, based on recent failures, regarding liability runoffs and the recovery value of asset categories are applied to calculate possible losses to the FDIC. The second measure is the ratio of secured liabilities to total domestic deposits. Like the Performance Score, the Loss Severity Score is subject to discretionary adjustment by the FDIC, subject to the same conditions.

c. Liability-Based Adjustments

The Proposal would continue to allow for significant adjustments to an institution's initial base assessment rate as a result of certain long-term unsecured debt, secured liabilities and brokered deposits. These adjustments are currently provided for in the assessments rule effective as of April 1, 2009, except that the brokered deposit adjustment currently applies only to institutions in Risk Categories II, III and IV. The Proposal would extend the brokered deposit adjustment to all large institutions since the adjusted brokered deposit ratio (which took brokered deposits and growth into account for large Risk Category I institutions) would no longer apply. The unsecured debt adjustment, secured liability

adjustment and brokered deposit adjustment would be applicable to both large institutions and highly complex institutions under the proposal.

III. Highly Complex Institution Scorecard and Base Assessment Rate

Institutions that meet the definition of “highly complex” would be subject to a more complex scorecard than ordinary large institutions. A highly complex institution would be defined as an insured depository institution with greater than \$50 billion in total assets that is fully owned by a parent company with more than \$500 billion in total assets. The designation also would apply to a processing bank and trust company with greater than \$10 billion in total assets. The scorecards for highly complex institutions and relevant adjustments thereto are identical to the scorecard and injunctions for large institutions, with the exception that the following measures will also be included:

- Senior bond spread
- Institution’s parent company’s tangible common equity (TCE) ratio
- 10-day 99 percent Value at Risk (VaR)/Tier 1 Capital
- Short-term funding to total assets ratio

Each of these measures is described in detail in Appendix B to the Proposal. The senior bond spread measure and the parent company’s TCE ratio are used to calculate the Market Indicator, which is in turn used as an additional weighted component in the Performance Score. The weights of the other components to the Performance Score are adjusted accordingly. The TCE ratio is used as an outlier add-on only, meaning that it is used only if it falls below a certain amount. The 10-day 99 percent Value at Risk (VaR)/Tier 1 Capital is used as an additional factor in the calculation of the Asset-Related Stress Component of the Performance Score. The short-term funding to total assets ratio is used as both a component and an outlier add-on in the calculation of the Funding-Related Stress Component of the Performance Score.

IV. Changes to Small Bank and Branches of Foreign Banks Assessment Rates

To maintain approximately the same total revenue under the Proposal as under the current system, under the Proposal, the range of initial base assessment rates for small institutions and insured branches of foreign banks in Risk Category I would be uniformly 2 basis points lower than under the current assessment system; the initial base assessment rate for institutions in Risk Category II would be unchanged; while the proposed initial base assessment rate for small institutions and insured branches in Risk categories III and IV would be somewhat higher.

V. Further FDIC Rights

a. FDIC Adjustment

Actual total assessment rates will be set uniformly 3 basis points higher than the proposed rates in accordance with the Amended Restoration Plan that the FDIC adopted on September 29, 2009. Under current rules, the FDIC has discretion to increase or decrease assessment rates in effect up to 3 basis points above or below total base assessment rates

without the need for additional rulemaking. The proposed rule would not affect this provision.

b. Cutoff Adjustments

The Proposal states that the FDIC shall have the flexibility to update the minimum and maximum cutoff values and weights used in each scorecard annually, without notice-and-comment rulemaking. In particular, the FDIC could add new data from each year to its analysis and could, from time to time, exclude data from some earlier years from its analysis.

VI. Request for Comments and FDIC Questions About Other Factors

There will be a 60-day public comment period upon publication of the Proposal in the *Federal Register*. In addition to comments on the Proposal, the FDIC seeks comment regarding whether, and by what method, additional measures and factors that should be incorporated into the assessment system in future rulemakings. These measures and factors include credit, liquidity, market, and interest rate stress tests, underwriting quality, counterparty risk, market risk, liquidity risk, systemic risk and capability of risk management. The FDIC is also seeking comments regarding whether the FDIC should review the assessment system applicable to small institutions to determine whether improvements, including improvements analogous to those being proposed for the large institution assessment system, should be made to the assessment system used for small institutions. If adopted, the Proposal would go into effect on January 1, 2011.

FinCEN Issues Final Rule Amending Certain BSA Requirements for Mutual Funds

The Financial Crimes Enforcement Network (“FinCEN”) issued a final rule (the “Final Rule”) that will amend the definition of “financial institution” in FinCEN’s regulations, which is less inclusive than the definition in the Bank Secrecy Act itself, to include mutual funds. A “mutual fund” will be defined for this purpose as “an ‘investment company’ (as the term is defined in Section 3 of the Investment Company Act (15 U.S.C. 80a-3)) that is an ‘open-end company’ (as that term is defined in Section 5 of the Investment Company Act (15 U.S.C. 80a-5)) registered or required to register with the Securities and Exchange Commission under section 8 of the Investment Company Act (15 U.S.C. 80a-8).” This definition matches the definition of mutual fund previously included in the Customer Identification Program (“CIP”) and Suspicious Activity Report (“SAR”) rules for mutual funds, but the addition of mutual funds to the regulatory definition of “financial institution” affects the applicability of certain other anti-money laundering (“AML”) requirements to mutual funds.

One consequence of expanding the definition of “financial institution” in FinCEN’s regulations to include mutual funds is that mutual funds, like banks and broker-dealers, will be required to report large currency transactions on currency transaction reports (“CTRs”) rather than Form 8300. The requirements for CTRs, which apply to financial institutions, are more limited in certain ways than the requirements for Form 8300, which apply to businesses more generally. For example, “currency” for purposes of the CTR requirement includes only cash, while Form 8300 applies to transactions involving certain cash-like instruments, such as travelers’ checks and money orders. In addition, the CTR rule requires consideration of reporting of multiple transactions resulting in cash in or cash out totaling

more than \$10,000 in a single business day, but a Form 8300 filing obligation can be triggered by transactions that occur over a longer period of time.

Another result of the rule amendment is that mutual funds will become subject to the so-called "Recordkeeping and Travel Rule," which will require mutual funds to create and retain records and include certain information (such as the name and address of the transmitter, date and amount of the transmittal order, and identity of the recipient's financial institution) in the transmittal order for wire transfers and other transmittals of funds in amounts of \$3,000 or more, subject to certain exceptions. In addition, mutual funds will be subject to recordkeeping obligations for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities and credit, if such transactions involve more than \$10,000.

The rule amendment also makes two clarifying changes to the AML regulations for mutual funds. First, the definition of "mutual fund" in the AML Program rule for mutual funds has been revised to add an explicit reference to open-end companies "registered or required to be registered under section 8 of the Investment Company Act," thereby conforming the definition with the definition of mutual fund in the CIP and SAR rules. In addition, FinCEN's regulations have been amended to clarify that the IRS does not have authority to examine mutual funds for BSA compliance. Previously, the regulations assigned such examination responsibility had been assigned to the SEC, but did not expressly limit the IRS's authority.

The rule amendments will take effect on May 14, 2010, and mutual funds will become subject to the CTR reporting requirements on that date. However, mutual funds will not be required to comply with Recordkeeping and Travel Rule requirements until January 10, 2011.

Federal District Court Denies Motion to Dismiss Class Action Suit Alleging Misrepresentations in Mutual Fund's Offering Documents

The U.S. District Court for the District of Massachusetts (the "Court") denied a motion to dismiss for failure to state a claim as to all but one of the claims in the complaint for a class action lawsuit filed by mutual fund investors against the fund, the fund's investment adviser, the adviser's parent, the adviser affiliate serving as the fund's distributor, certain executives of the adviser and the fund's trustees. The complaint asserted violations of the federal securities laws under Section 11 and 12(a)(2) of the Securities Act of 1933, as amended (the "Act"), and control person liability under Section 15 of the Act. Plaintiffs alleged that defendants misrepresented the nature of the fund's investment objective and strategy in the fund's offering documents as a safe, liquid and stable investment offering when the fund was comprised of illiquid, risky and volatile securities.

Background. The plaintiffs alleged that during the period between October 28, 2005 and June 23, 2008, the fund's net asset value ("NAV") ranged from \$9 to \$10 per share, due at least partly to defendants' artificial inflation of the fund's NAV. Eventually, according to the plaintiffs, the fund's assets were re-priced and the fund was ultimately liquidated with significant losses to the fund's investors. Plaintiffs alleged that they lost approximately 25% of the value of their fund investments because of defendants' misrepresentations in the fund's offering documents that included: (i) misleading statements about the fund's objectives, (ii) misrepresentations about the fund's holdings of illiquid assets and (iii) misleading statements comparing the fund to certain securities indices.

Fund Objective. The fund's investment objective as set forth in its offering materials was to "seek to provide income consistent with preservation of capital and low principal fluctuation" and included the statement that "the fund seeks to provide investors with a high level of current income while reducing price volatility." The offering documents stated that the fund's investment strategy was "to seek the highest total return by maximizing income and minimizing price fluctuations." Defendants argued that these statements were simply "general and indefinite" statements of objective which are not actionable under securities laws. The Court, however, found that the statements in the fund's prospectus were more than "mere aspirations" and instead were properly viewed as "key guidelines that established the [f]und's investment strategy and laid down the basic ground rules it would follow." The Court also found that, although the fund's prospectus contained general statements of the fund's goals, these statements were nevertheless surrounded by more detailed specific statements about the fund which clarified the context in which the more general statements appeared and which, when read together, "made distinct claims about the posture of the [f]und, its investment strategies and the rules under which it would operate." For example, the fund's prospectus stated that the fund intended to maintain an average portfolio duration of one year or less, that it would not invest more than 15% of its net assets in illiquid securities and that its returns would be comparable to those in certain specific indices.

Defendants also argued that the statements about the fund's objectives were not actionable since the prospectus contained language that "bespoke caution" about the risks of investing in the fund. The Court found that the bespeaks caution doctrine only applies to soft, future-looking statements and does not apply to statements of present fact like those contained in the fund prospectus which laid out the "ground rules" for the fund. In addition, the Court found that the warning contained in the prospectus that the fund is not guaranteed to meet its goals did not specifically warn of the alleged risky nature of the fund's investments so as to "bespeak caution."

Fund's Holding of Illiquid Assets. Plaintiffs alleged that the fund's offering documents misrepresented the extent of the fund's investments in illiquid assets by stating that the fund would not invest more than 15% of its net assets in illiquid securities when, in reality, the fund invested a much greater portion of its assets in private placement securities ("Rule 144A Securities") that were illiquid. Defendants argued that there was no basis for finding that the Rule 144A Securities in which the fund invested were illiquid. Noting plaintiffs' "detailed allegations concerning the inherent illiquidity of Rule 144A Securities," the Court indicated that a factual dispute regarding whether such securities were illiquid could not be resolved by the Court on a motion to dismiss for failure to state a claim.

Comparison of the Fund to Indices. The fund's offering documents contained a series of statements comparing the fund to certain named indices. Plaintiffs alleged that the comparisons of the fund to these indices were materially misleading because the fund's longer portfolio duration made it much more susceptible to unanticipated changes in interest rates and therefore riskier than the indices. Defendants argued that these statements were merely intended to provide some basis for comparison as opposed to an exhaustive description of the fund's risks. The Court found that the fund's offering documents had in fact invited investors to use the index comparisons to assess the fund's risks since the materials clearly stated that the comparisons were "intended to provide . . . some indication of the risks in investing in the fund" and held that the plaintiffs' allegations regarding

statements comparing the fund to certain indices, in conjunction with other alleged misrepresentations, stated a claim under Sections 11 and 12 of the Act.

Loss Causation. In response to defendants' argument that plaintiffs had failed to plead loss causation, the Court observed that although Sections 11 and 12(a) of the Act require a causal link between defendants' misstatements and plaintiffs' economic loss, loss causation is not an element of a prima facie case under Sections 11 and 12. Nevertheless, the Court noted that courts have occasionally dismissed claims under Sections 11 and 12 when it was "apparent on the face of the complaint that plaintiffs would not be able to establish loss causation."

Specifically, defendants argued that, even if there were misstatements about the fund's investment strategy and risk profile in the fund's offering documents, plaintiffs' economic loss could not have been caused by such misstatements because the price of the fund's shares was determined by the fund's NAV whose decline resulted from the depreciation and re-valuation of the underlying assets held by the fund, rather than from any misstatements in the fund's offering documents.

The Court found that defendants' view of loss causation was "too narrow," citing *In re Charles Schwab Corp. Sec. Litig.*, 257 F.R.D. 534 (N.D. Cal. 2009) ("Schwab") which, in rejecting arguments similar to those made by the defendants in the present case, noted that "[such a narrow formulation of loss causation] would effectively insulate mutual fund companies from claims for a wide range of material misrepresentations regarding fund policies, risks and investment decisions . . . [and] would immunize a scheme that purported to invest in low-risk [securities] but in fact invested in legitimate but high risk [securities]." Again citing Schwab, the Court indicated that "loss causation is 'not limited to the common 'corrective-disclosure-price drop scenario,' in which the alleged misrepresentation [is] followed by a corrective disclosure that [leads] indirectly to a drop in share price." In this regard, the Court stated that "[a] plaintiff may also establish loss causation by alleging that 'the subject of the fraudulent statement or omission was the cause of the actual loss suffered [or] that [the] defendants' misstatements and omissions concealed the price-volatility risk . . . that materialized and played some part in diminishing the market value of the security.'"

The Court noted that plaintiffs alleged that "defendants made false representations about the riskiness of the fund's investments and artificially inflated the NAV" during the relevant time period and that "when the alleged misstatements were ultimately revealed, the NAV declined in value, resulting in losses to the fund." Ultimately, the Court found that such "allegations [were] sufficient to demonstrate that there is a colorable claim of loss causation which is all that is required to survive a motion to dismiss."

Dismissal of Section 12(a)(2) Claims Against the Fund's Trustees. The Court granted the dismissal of plaintiffs' Section 12(a)(2) claims against the fund's trustees on the ground that plaintiffs had failed to establish that the trustees were "sellers" within the meaning of Section 12(a)(2). Section 12(a)(2) of the Act imposes liability on any person who "offers or sells" a security by means of a prospectus or oral communication containing a material misstatement or misleading omission. Plaintiffs alleged that the individual trustees signed the registration statements and participated in the drafting, preparation and/or approval of the fund's offering materials. In dismissing the Section 12(a)(2) claims against the fund's trustees, the Court indicated that it was following the precedent set in *Shaw v. Digital Equip Corp.*, 82 F.3d 1194 (1st Cir. 1996), which held that "such acts are insufficient to establish a statutory seller relationship with the plaintiffs."

GOODWIN PROCTER FINANCIAL SERVICES PRACTICE

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Dismissal of Section 15 Claim Against the Fund's Trustees Denied. The Court denied the trustee defendants' motion to dismiss plaintiffs' Section 15 control person liability claim. Section 15 of the Act provides for joint and several liability for persons who control any person liable under Sections 11 or 12 of the Act. The trustee defendants argued that their "mere status as a director or trustee [was] insufficient to demonstrate control under Section 15" and that accordingly, plaintiffs had not sufficiently alleged that the trustees exercised "control" over the fund. Plaintiffs, on the other hand, argued that "the individual defendants were 'culpable participants' in the violations of Sections 11 and 12 based on their having signed or authorized the signing of one or more registration statements and having otherwise participated in the process which allowed the offerings to be successfully completed." In particular, plaintiffs' complaint alleged that each trustee "participated in the drafting, preparation, and/or approval of various untrue and misleading statements" and that the trustees had the "power and influence to direct the management and activities of [the] [f]und and its employees [and, accordingly,] were able to, and did, control the contents of the [o]ffering [m]aterials." Ultimately, the Court found that plaintiffs' allegations of control with respect to the trustees were sufficient to withstand a motion to dismiss. The Court also noted that whether a defendant is a "controlling person" is typically a question of fact that cannot be resolved on a motion to dismiss for failure to state a claim.

SEC Proposes Large Trader Reporting System

The SEC has proposed Rule 13h-1 under the Securities Exchange Act of 1934 (the "1934 Act") which would establish a large trader reporting system under Section 13(h) of the 1934 Act. The [proposed rule](#) is designed to enable the SEC to identify, and obtain certain baseline trading information about, traders that conduct a substantial amount of trading activity. The proposal would affect traders whose transactions in NMS (national market securities) equal or exceed two million shares or \$20 million during any calendar day, or 20 million shares or \$200 million in any calendar month ("Large Traders"). Large Traders would be required to identify themselves to the SEC and the broker-dealers they use, and make certain disclosures to the SEC on proposed Form 13H. Broker-dealers would be required to (a) maintain transaction records for each Large Trader which would be subject to SEC review, and (b) monitor customer activity for compliance with the reporting requirements of Rule 13h-1. Comments on the proposal are due 60 days after its publication in the *Federal Register*.

OTHER ITEM OF NOTE

Regulatory Agencies Make Available Online Model Privacy Notice Form Builder

The federal bank regulatory agencies, NCUA, SEC, CFTC and FTC jointly released an [online utility for generating model privacy notices](#). The agencies issued a final model privacy notice in November 2009 (as discussed in the [November 24, 2009 Alert](#)). The form builder assists entities in creating a model privacy notice by providing a series of amendable PDF documents with the appropriate document determined by the entity's information sharing practices. Use of the model notice form provides a compliance safe harbor with respect to privacy notices required under the Gramm-Leach-Bliley Act and implementing regulations.

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