

Financial Services Alert

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Developments of Note

➤ **Seventh Circuit Denies Petition for Rehearing and Rehearing En Banc of Decision Rejecting Gartenberg Analysis in Excessive Fee Suit Against Mutual Fund Adviser**

A panel of the US Court of Appeals for the Seventh Circuit (the “Seventh Circuit”) voted unanimously to deny a petition for rehearing of its decision (the “Decision”) that affirmed the dismissal by the US District Court for the Northern District of Illinois (Eastern Division) (the “District Court”) of an excessive fee suit brought under Section 36(b) of the Investment Company Act of 1940, as amended (the “1940 Act”), against an adviser (the “Adviser”) of registered open-end funds (the “Funds”) by Fund shareholders. Although it affirmed the District Court’s decision, the Decision explicitly rejected the approach the multi-factor analysis for suits under Section 36(b) of the 1940 Act established by the US Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F2d 923 (2d Cir. 1982) (“Gartenberg”). Gartenberg has been followed by district courts in other circuits and relied on by the SEC in establishing disclosure requirements for board approval of advisory contracts. The Decision also expressly rejected the plaintiffs’ claim that mutual fund fees must be judged against the fees charged to an adviser’s institutional clients. (See the June 3, 2008 *Alert* for a more detailed discussion of the Decision.)

A request that the Decision be reheard en banc, which requires a majority vote of the panel, or of the judges in active service, was also denied. Judge Posner joined by four other Circuit Judges filed a dissent to the denial. Like Judge Easterbrook, who wrote the Decision, Judge Posner is known for his economics-based approach to legal issues. While acknowledging that the outcome may be correct, the dissent takes issue with many aspects of the Decision, devoting particular attention to the Decision’s economic analysis and the basis on which the Decision dismisses the plaintiffs’ arguments regarding the differential between advisory fees charged mutual funds and those charged similarly managed institutional accounts. The dissent also cites the fact that the Decision is recognized as having created a split in the circuits although the panel making the Decision did not acknowledge this, or as required when its opinion would result in a split in the circuits, circulate the opinion to the full court in advance of publication.

➤ SEC Issues Interpretive Release Regarding Use of Company Websites under Federal Securities Laws

The SEC issued an interpretive release principally addressing the following issues related to the use of company websites and the federal securities laws: (a) when information posted on a company website is “public” for purposes of Regulation FD; and (b) how previously posted information, hyperlinks to third-party information, summary information and interactive content are treated under the anti-fraud provisions of the federal securities laws. The interpretive release also includes an overview of the rules under the Securities Exchange Act of 1934, as amended (the “1934 Act”), as they apply to the use of company websites.

Regulation FD. In general terms, Reg. FD does not permit a company’s senior officers or other personnel who regularly communicate with securities market professionals or the company’s security holders to communicate material non-public information about a publicly traded company to securities market professionals or security holders who are likely to use the information in buying or selling the company’s securities unless the company makes or has made public disclosure of that information. The discussion in the interpretive release addressing Reg. FD focuses in part on analyzing when information posted on a company website would be considered “public” for purposes of evaluating how Reg. FD applies to subsequent private disclosure of the posted information. Under the interpretive release, this entails an analysis consisting of three elements, as follows:

- Whether and when a company website is a recognized channel of distribution;
- Whether and when posting of information on a company website disseminates the information in a manner making it available to the securities marketplace in general; and
- Whether and when there has been a reasonable waiting period for investors and the market to react to the posted information.

The interpretive release cites a range of considerations as relevant to the first and second elements of the analysis, including a company’s past practice, the extent to which the company has publicized the fact that it will post important information on its website, the steps the company has taken to make its website accessible (*e.g.*, through the use of “push” technology like RSS feeds), and the extent to which information posted on a company’s website is regularly picked up by the market and readily available media.

The interpretive release also provides a list of considerations for evaluating the third element of the analysis, which overlap with those identified for the first two. The interpretive release emphasizes that the reasonable waiting period element involves a facts and circumstances determination that will vary depending upon the particular company and the particular type of information. The release goes on to suggest that if information is important, a company should consider taking additional steps to alert investors and the market, for example, by filing the information with, or furnishing it to, the SEC prior to the posting, or issuing a press release that announces the date and time of the anticipated posting and the other steps the company intends to take to provide the information. On the question of what constitutes a reasonable waiting period, the interpretive release indicates that the treatment of this issue in the case law relating to insider trading may be instructive.

The interpretive release also focuses on whether posting on a company website information that has not previously been made public satisfies the “public disclosure” requirement of Reg. FD that applies when a company makes private or “selective” disclosure of that information. Specifically, Reg. FD provides that once a selective disclosure has been made, the company must file or furnish a Form 8-K or use an alternative method or methods of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public – simultaneously, in the case of an intentional disclosure, or promptly, in the case of an unintentional disclosure. The interpretive release directs a company undertaking this analysis to the considerations listed for the first two elements of the

prescribed analysis for determining whether or not a website posting makes information “public” for purposes of Reg. D (as discussed above).

Anti-Fraud Issues - Previously Posted Materials. In response to concerns expressed regarding whether previously posted materials or statements on a company’s website accessed at a later time would be considered “republished” on the date of access, the interpretive release indicates that the fact that investors can access previously posted materials or statements on a company’s website does not, by itself, mean that (1) the previously posted materials or statements have been reissued or republished for purposes of the anti-fraud provisions of the federal securities laws, (2) the company has made a new statement, or (3) the company has created a duty to update the materials or statements. In circumstances where it is not apparent to the reasonable person that the posted materials or statements speak as of a certain date or earlier, the interpretive release suggests that those materials or statements be separately identified as historical or previously posted materials or statements and that they be located in a separate section of the company’s website.

Anti-Fraud Issues - Hyperlinks to Third-Party Information. The interpretive release reiterates the SEC’s position stated in its 2000 release on use of electronic media that third-party information to which a company hyperlinks from its website may be attributable to a company for purposes of liability under Section 10(b) of the 1934 Act and Rule 10(b)-5 under the 1934 Act depending on whether a company has: (1) involved itself in the preparation of the information or (2) explicitly or implicitly endorsed or approved the information (the “Adoption Theory”).

The interpretive release focuses on the Adoption Theory and, in particular, how the context of a hyperlink and the hyperlinked information can create a reasonable inference that the company has approved or endorsed the hyperlinked information. In addition, the nature and content of the hyperlinked information and the degree to which a company is making a selective choice to hyperlink to a specific piece of third-party information may be indicative of the extent to which the company has a positive view or opinion about that information. The interpretive release suggests that in a situation where a company website includes a hyperlink to a news article that is highly laudatory of management, the company consider explanatory language about the source and the company’s reasons for providing the hyperlink in order to avoid the inference that the company is commenting favorably on the article’s accuracy, or was involved in the article’s preparation. In contrast, with more general or broad-based hyperlink information, a more general explanation may be sufficient, *e.g.*, where a company maintains a media page that provides hyperlinks to recent news articles, both positive and negative, about the company.

The interpretive release notes the use of “exit notices” or “intermediate screens” to indicate that the viewer is accessing third-party information, but cautions that no one type of “exit notice” or “intermediate screen” will absolve companies from anti-fraud liability for third-party hyperlinked information, and warns that a disclaimer would not shield a company from anti-fraud liability for hyperlinking to information it knows, or is reckless in not knowing, is materially false or misleading.

Anti-Fraud Issues - Summary Information. While noting the SEC’s belief that the use of summaries or overviews on websites can be helpful to investors, the interpretive release suggests that companies should consider ways to alert readers to the location of detailed disclosure from which summary information is derived, as well as to other information about a company on its website. The interpretive release discusses a number of techniques to identify summary information, including use of appropriate titles, use of additional explanatory language, use hyperlinks to more detailed information, and use of a layered or tiered format that presents the most important summary or overview information about a company on the opening page, with embedded links that enable the reader to access greater detail.

Anti-Fraud Issues - Interactive Website Features (Electronic Shareholder Forums and Blogs). The interpretive release cautions that while electronic shareholder forums and blogs may be informal and conversational in nature, statements made by a company on a shareholder forum or blog are treated no

differently from other company statements under the anti-fraud provisions of the federal securities laws. In addition, the interpretive release states that any term or condition of a shareholder forum or blog requiring users to agree not to make investment decisions based on the forum's or blog's content or disclaiming liability for damages of any kind arising from the use or inability to use the blog or forum is inconsistent with the federal securities laws and violates the anti-waiver provisions of the federal securities laws.

Company Websites and Sarbanes-Oxley Disclosure Controls and Procedures. The interpretive release notes that website disclosures are generally not subject to the periodic evaluations of, and related certifications regarding, the effectiveness of an issuer's disclosure controls and procedures required under form and rule amendments adopted pursuant to the Sarbanes-Oxley Act. However, to the extent an issuer elects to satisfy disclosure obligations, such as those relating to its Sarbanes-Oxley code of ethics for certain senior executive officers, by posting information on its website, the controls and procedures for those disclosures will be subject to the required periodic evaluation and certification.

Readability/Printability of Information. The interpretive release provides that information appearing on a company website need not be printer-friendly unless SEC rules expressly require it to be.

Effectiveness/Request For Comment. The interpretive release, which was effective August 7, 2008, requests comment on "any other approaches or issues involved in facilitating the use of electronic media, including as a result of technological developments, to further the disclosure purposes of the federal securities laws." Comments must be received on or before November 5, 2008.

➤ **FRB Proposes Changes to Regulation S**

The FRB proposed changes (the "Proposed Amendments") to Subpart A of Regulation S (12 CFR Part 219, issued under Section 1115 of the Right to Financial Privacy Act) which sets the rates at which government agencies must reimburse financial institutions for costs incurred in producing customer financial records. Regulation S has not been updated since 1996, when document productions were generally made on paper. The FRB said that the Proposed Amendments are intended to encourage electronic document production by eliminating the \$.25 per page fee for printing electronically-stored information (other than if the governmental agency specifically requires a paper copy or if the original records are available only in paper form). The Proposed Amendments also increase the fees that financial institutions may charge for the time of personnel needed to research and process document requests. The Proposed Amendments include use of an automated mechanism for periodically updating labor rates in Regulation S based on changes in Bureau of Labor Statistics survey data. Comments on the Proposed Amendments are due by September 29, 2008.

➤ **SEC Staff Posts On-Line Mutual Fund AML Reference and Launches SAR Phone Line**

The SEC staff added an online reference to its website designed to assist mutual fund anti-money laundering ("AML") compliance efforts, and launched a new centralized phone line specifically for securities firms to report the filing of a Suspicious Activity Report ("SAR") that may require immediate attention by the SEC. The AML Source Tool for Mutual Funds, originally developed for use by examiners in the SEC's Office of Compliance Inspections and Examinations, provides links to key AML laws, rules and related guidance. The new SEC SAR Alert Message Line (202-551-SARS (7277)) is designed for situations where a securities firm has filed a SAR that may require immediate attention by the Commission. The SEC press release announcing the SAR Alert Message Line cautions that calling the Message Line does not affect a firm's obligation to file a SAR or notify an appropriate law enforcement authority, such as a local office of either the Internal Revenue Service Criminal Investigation Division or the FBI.

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Other Item of Note

➤ **IOSCO Issues Final Report on Funds of Hedge Funds**

IOSCO issued a final report on funds of hedge funds that issue shares to retail investors. The report (i) provides an overview of current and proposed regulation of funds of hedge funds in various jurisdictions; (ii) identifies issues of concern to regulators; and (iii) proposes the development of guidelines for managers of funds of hedge funds to use in addressing liquidity risk and in carrying out due diligence both before and after investment. The final report also reflects responses to IOSCO's April 2007 report seeking comment on issues related to funds of hedge funds and views expressed by fund of hedge fund industry participants at a series of 2007 hearings held by IOSCO in Washington, DC, Paris and Hong Kong.