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7
8 UNITED STATES DISTRICT COURT
9 NORTHERN DISTRICT OF CALIFORNIA
10 SAN FRANCISCO DIVISION
11

12
13 IN RE CHARLES SCHWAB CORP.
SECURITIES LITIGATION

Master File No. C-08-01510-WHA

CLASS ACTION

BRIEF OF THE INVESTMENT COMPANY
INSTITUTE, AS *AMICUS CURIAE*

Date: March 25, 2010

Time: 8:00 a.m.

Judge: Hon. William H. Alsup

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1 The Investment Company Institute (“ICI”), as *amicus curiae*, respectfully submits this
2 memorandum to the Court, to provide the proper interpretation of sections 8(b) and 13(a)(3) of
3 the Investment Company Act of 1940 (“ICA” or “Act”) as applied to changes in the industry
4 classifications employed by a mutual fund subject to the Act.

5 **INTEREST OF THE AMICUS**

6 ICI is the national association of U.S. investment companies, including mutual funds,
7 closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts. ICI members
8 collectively manage approximately \$11.55 trillion in total assets on behalf of nearly 90 million
9 investors.

10 Since ICI’s founding almost 70 years ago, one of its main objectives has been to protect
11 and affirmatively advance the interests of mutual fund shareholders through advocacy directed at
12 ensuring a sound legal and regulatory framework for the mutual fund industry. In pursuit of this
13 objective, ICI regularly engages in legislative, regulatory, and other initiatives aimed at increasing
14 government and public awareness of issues affecting investment companies and their
15 shareholders.

16 Because of its membership, mission, expertise, and experience, ICI is uniquely positioned
17 to address the question presented in this case: When does a Board have the discretion to modify
18 the standards or methods that a mutual fund uses to implement fundamental policies; and, more
19 particularly, under what circumstances can a Board modify the industry classifications that the
20 fund uses to implement its fundamental policy to either concentrate or not concentrate its
21 investments?

22 **SUMMARY**

23 Together, sections 8(b) and 13(a) of the ICA set forth the types of policies that a fund
24 cannot change without shareholder approval. 15 U.S.C. § 80a-8(b), 13(a). Under these sections,
25 a fund’s general policy to concentrate its investments in a particular industry (or group of
26 industries), or not to do so, is distinct from the industry classifications a fund uses to implement
27 that policy. Although the general concentration policy itself cannot be changed by a fund without
28 shareholder consent; just as clearly, these statutory provisions do not limit the Board’s ability to

1 make changes to the industry classifications without such a vote. Accordingly, a mutual fund
2 Board ordinarily has the discretion to change the particular industry classifications used by the
3 fund.

4 There are exceptions to this rule, but they are both limited and specific. As explained
5 below, changes to a fund's industry classifications are subject to shareholder approval only if the
6 fund affirmatively states in its registration statement that its industry classifications are: (1)
7 expressly incorporated into its concentration policy; (2) themselves deemed by the fund to be a
8 fundamental policy; or (3) deemed by the fund to be subject to shareholder approval. Where such
9 disclosures are not made, under a straightforward application of sections 8(b) and 13(a), a fund
10 Board remains free to adopt or alter the fund's industry classifications without shareholder
11 approval.

12 The undisputed facts at issue here show that the YieldPlus Fund had the discretion to
13 change its industry classifications. The concentration policy recited in the Fund's November
14 2005 Statement of Additional Information ("SAI") did not expressly incorporate the Fund's
15 method for classifying non-agency mortgage-backed securities. Likewise, the Fund did not label
16 that method a "fundamental" policy or say that it could be changed only by shareholder vote. To
17 the contrary, the industry classification was listed among other policies that the Fund told
18 investors could be changed *without* shareholder approval. Accordingly, the YieldPlus Fund's
19 Board had the discretion to change the classification without shareholder approval.

20 BACKGROUND

21 The ICA and related regulations promulgated by the Securities and Exchange Commission
22 ("SEC") govern the required content of the registration statements of investment companies,
23 including mutual funds.¹ Particularly relevant to this case is section 8(b)(1) of the ICA, which
24 requires a mutual fund's registration statement to recite the fund's policies on eight specific topics,
25 including its policy on "concentrating investments in a particular industry or group of industries."
26 15 U.S.C. § 80a-8(b)(1)(E). In addition, sections 8(b)(2) and 8(b)(3) require the fund's

27 ¹ While this brief speaks in terms of mutual funds, we note that the same analysis would
28 apply to closed-end funds and ETFs.

1 registration statement to disclose any other policies that are “changeable only if authorized by
 2 shareholder vote” or “matters which the [fund] deems matters of fundamental policy.” *Id.* §§
 3 80a-8(b)(2)-(3). Section 13(a)(3) of the Act requires funds to obtain shareholder approval before
 4 changing or deviating from any of these policies. *See* 15 U.S.C. § 80a-13(a)(3).

5 Additional disclosure obligations are contained in SEC Form N-1A, the form on which
 6 mutual funds file both initial fund registration statements and periodic updates to them. *See* 17
 7 C.F.R. §§ 239.15A, 274.11A. Form N-1A includes a “Part A” that covers information that must
 8 be disclosed in a fund’s prospectus, and a “Part B” that covers additional information that must be
 9 included in the fund’s SAI. *See General Instructions to Form N-1A* at 7.² The prospectus
 10 provides “essential information about the Fund,” while the SAI includes “information about the
 11 Fund that the Commission has concluded is not necessary or appropriate in the public interest or
 12 for the protection of investors to be in the prospectus, but that some investors may find useful.”
 13 *Id.*

14 Whether the policy on “concentrating investments in a particular industry or group of
 15 industries” required by section 8(b)(1) is “essential information” that must be disclosed in a
 16 fund’s prospectus, or non-essential information to be disclosed in the SAI for the benefit of some
 17 interested investors, depends on the content of that policy. If a Fund does intend to concentrate
 18 its investments in an industry or group of industries, then it must disclose that policy in its
 19 prospectus. *See* Form N-1A, Items 2 at 11, 4(a) at 16 and 9(b)(1) at 21, Instruction 4. Conversely,
 20 if a Fund does *not* intend to concentrate its investments, it is only required to disclose that policy
 21 in its SAI. *See id.*, Item 16(c)(1)(iv) at 31.³

22
 23 ² Citations in this brief are to the current Form N-1A. *See* Registration Statement for Open-
 24 End Management Investment Companies, available at
 25 <http://www.sec.gov/about/forms/secforms.htm>. All relevant information concerning a
 Fund’s concentration policy is substantively similar in both the current Form N-1A and
 the operative Form N-1A at the time of the Yield Plus Fund’s disclosures.

26 ³ In addition, a mutual fund’s SAI must disclose “[a]ny other policy that *the Fund deems*
 27 fundamental or that may not be changed without shareholder approval,” *i.e.*, the additional
 28 disclosures required by sections 8(b)(2) and 8(b)(3) of the ICA. Form N-1A, Item
 16(c)(1)(vii) at 31(emphasis added).

1 No provision of the ICA or Form N-1A requires a mutual fund that has elected not to
 2 concentrate in any particular industry to disclose the industry classifications it uses to implement
 3 that policy. As a result, many funds do not disclose their industry classifications in either the
 4 prospectus or the SAI.

5 DISCUSSION

6 This case involves the question of whether section 13(a)(3) of the ICA requires a mutual
 7 fund to obtain shareholder approval before changing a previously disclosed industry classification.
 8 Section 13(a)(3) works in tandem with section 8(b). It requires a mutual fund to obtain
 9 shareholder approval before deviating from three categories of policies that section 8(b) requires
 10 the fund to disclose:

11 No [mutual fund] shall, unless authorized by the vote of a majority of its
 12 outstanding voting securities . . . [1] deviate from its policy in respect of
 13 concentration of investments in any particular industry or group of industries as
 14 recited in its registration statement, [2] deviate from any investment policy which
 15 is changeable only if authorized by shareholder vote, or [3] deviate from any
 policy recited in its registration statement pursuant to section 80a-8(b)(3) of this
 title [*i.e.*, “matters which the [fund] deems matters of fundamental policy”].

16 15 U.S.C. § 80a-13(a)(3). While a mutual fund’s concentration policy itself is always subject to
 17 section 13(a)(3), the fund’s industry classifications may or may not fall into any of section
 18 13(a)(3)’s three categories.

19 If a previously disclosed industry classification does not fall within any of the prescribed
 20 categories in section 13(a)(3), then the fund’s Board has the discretion to change the classification
 21 without shareholder approval. This outcome is consistent with the routine application of the ICA
 22 to mutual funds, which affords fund Boards considerable discretion in structuring a fund.⁴
 23 Protecting the exercise of that discretion is essential to furthering both the interests of
 24 shareholders and the basic purposes underlying the ICA.

25 ⁴ For example, a mutual fund’s Board must make judgment calls about which investment
 26 strategies should be used to achieve the fund’s investment objective (*e.g.*, *Lapidus v.*
 27 *Hecht*, No. C 98-3130 MMC, 2002 WL 1034042, at *4 (N.D. Cal. May 17, 2002)),
 whether the fund’s investments are consistent with its name (66 Fed. Reg. 8,509, 8,513-14
 28 (Feb. 1, 2001)), the terms of the advisory contract with the fund’s investment adviser (15
 U.S.C. § 80a-15(c)), and the fund’s method for valuing certain types of securities (15
 U.S.C. § 80a-2(a)(41)(B)(ii)).

1 **A. An Industry Classification Is Covered By The First Category Of Section**
 2 **13(a)(3) Only If It Is Expressly Incorporated By Reference Into The Fund’s**
 3 **Concentration Policy.**

4 The first category of section 13(a)(3) covers a fund’s “policy in respect of concentration
 5 of investments in any particular industry or group of industries as recited in its registration
 6 statement.” 15 U.S.C. § 80a-13(a)(3). Two different lines of SEC guidance make clear that, in
 7 the normal course, a fund’s specific industry classifications are *not* part of the “policy in respect
 8 of concentration” covered by this language.

9 *First*, the SEC has always explained that the concentration “policy” referred to in sections
 10 8(b)(1) and 13(a)(3) need only declare the answer to the *general* question of whether or not the
 11 fund will concentrate in any industry or groups of industries. The policy does not need to include
 12 a detailed explanation of how the policy will be applied, particularly in the case of a fund’s
 13 election not to concentrate. For example, nearly 40 years ago the SEC explained that an
 14 “acceptable” policy not to concentrate under section 8(b)(1) could be written *in full* this way:

15 [The Fund] will not concentrate its investments in any industry. No more than
 16 25% of the value of its assets will be invested in any one industry.

17 *See Guidelines For The Preparation of Form N-8B-1*, 972 SEC LEXIS 1494, at *25 (June 9,
 18 1972).⁵

19 Notably, this model policy did not purport to define “industry” in any particular way, nor
 20 does it suggest that the fund is bound to any particular set of industry classifications. Instead, this
 21 policy leaves the crafting and revision of specific industry classifications to the discretion of the
 22 fund’s Board. Funds that choose to list their industry classifications in their registration
 23 statements sometimes include an express statement that the classifications are *not* fundamental
 24 policies. The SEC staff has apparently not objected to this practice. *See, e.g.*, Oppenheimer
 25 Principal Protected Trust, SEC Staff Review Ltr., 2003 WL 25299245, at *11 (Feb. 21,

26 ⁵ With the adoption of Form N-1A, the SEC no longer published model language for
 27 fundamental investment policies. *See generally* Final Rule, *Registration Form Used By*
 28 *Open-End Management Investment Companies*, 48 Fed. Reg. 37,928 (Aug. 22, 1983).
 Nevertheless, many fund groups continue to use the model language previously published
 by the SEC, and the SEC has never stated that the use of such language would be
 inappropriate.

1 2003)(asking a fund to “clarify” whether a disclosure is “referring to the industry classifications
2 that the Fund has adopted as *not being a fundamental policy*”)(emphasis added).

3 *Second*, industry classifications are demonstrably not an inherent part of the “policy” on
4 concentration referred to in sections 8(b)(1) and 13(a)(3) because they do not have to be disclosed.
5 Neither the Investment Company Act nor SEC regulations nor Form N-1A requires a fund that
6 elects not to concentrate to disclose industry classifications. Plaintiffs suggest otherwise by citing
7 to Guide 19, an outdated guideline that SEC staff members prepared for registrants filing a prior
8 version of Form N-1A. *See* Plaintiffs’ Br. at 15-16. The SEC first adopted Form N-1A in 1983.
9 In the adopting release accompanying the new form, the SEC published a series of guides that its
10 staff had prepared to assist registrants in filling out the form. The release, however, was careful
11 to point out that “publication of the views of the staff does not afford those views any legal status
12 they would not otherwise have.” Final Rule, *Registration Form Used by Open-End Management*
13 *Investment Companies*, 48 Fed. Reg. 37,928, 37,938 (Aug. 22, 1983).⁶ The guides themselves
14 also emphasized that they “are not rules of the Commission and, except as noted herein, represent
15 the views of the staff . . . rather than an official position of the Commission.” *Id.* at 37,958. In
16 any event, it is notable that Guide 19 specifically addressed registrants’ choice in defining
17 industry classifications, but did not say that industry classifications were an integral part of the
18 fund’s concentration policy or say that those classifications should be treated as fundamental.
19 Instead, Guide 19 merely stated that industry classifications selected by a registrant must be
20 “reasonable” and “should” be disclosed in the fund’s registration statement. *Id.* at 37,962.

21 In 1998, the SEC overhauled Form N-1A. The adopting release for the new form noted
22 that, among other shortcomings, the old guides had “not been reviewed since 1983” and some of
23 them had become “outdated.” Final Rule, *Registration Form Used by Open-End Management*
24 *Investment Companies*, 63 Fed. Reg. 13,916, 13,940 (Mar. 23, 1998). Therefore, the SEC elected
25 not to republish the guides and stated that they would not apply to “registration statements

26 ⁶ When it revised Form N-1A in 1998, the SEC reiterated this point by noting that “the
27 publication of the Guides was not intended to elevate their status beyond that of staff
28 guidance.” Final Rule, *Registration Form Used by Open-End Management Investment*
Companies, 63 Fed. Reg. at 13,940 n.209 (Mar. 23, 1998).

1 prepared on the amended Form.” *Id.* at 13,940 n.214.⁷ Instead, the SEC explained that amended
 2 Form N-1A itself included certain disclosure requirements previously discussed in the guides and
 3 that in adopting the amended form, the Commission deliberately omitted other requirements that
 4 had been discussed in the guides. *See id.* at 13,940. As a result, the SEC informed registrants
 5 that the amended form itself “includes all of the requirements necessary for funds to prepare new
 6 or amend existing registration statements.” *Id.*⁸

7 Of significance here, nothing in Form N-1A or its instructions says that a fund that elects
 8 not to concentrate must, or even “should”, disclose its industry classifications. Thus, there is no
 9 applicable support for the proposition that funds that elect not to concentrate are required to
 10 disclose their industry classifications, and most funds today do not do so. But the plain language
 11 of section 13(a)(3) covers only deviations from policies that are recited in registration statements
 12 pursuant to section 8(b)(1). Because industry classifications do not have to be recited in the
 13 registration statement, it follows *a fortiori* that, in general, they are not a necessary or integral part
 14 of the concentration “policy” referred to in sections 8(b)(1) and 13(a)(3). *Cf. Krouner v. Am.*
 15 *Heritage Fund, Inc.*, 899 F. Supp. 142, 148-49 (S.D.N.Y. 1995)(no section 13(a)(3) violation
 16 stated where the purportedly inappropriate activity was not prohibited by an express fundamental
 17 policy); *Leighton v. The One William Street Fund, Inc.*, [1964-66 Transfer Binder] Fed. Sec. L.
 18 Rep. ¶91,561 (S.D.N.Y. July 2, 1965)(same).

19 That being said, under sections 8(b)(1) and 13(a)(3), a fund does have the discretion to
 20 affirmatively adopt a concentration “policy” that includes its industry classifications. If a fund
 21 desired this result, it must use clear language that expressly incorporates industry classifications
 22 disclosed elsewhere in the registration statement into its concentration policy. For example, a
 23 fund could have the following concentration policy:

24 _____
 25 ⁷ To be sure, practitioners and the SEC staff occasionally refer to these guides when they
 26 discuss obligations that were retained in the revised Form N-1A. But these superseded
 guides do not create disclosure obligations that the SEC chose not to include in the revised
 Form N-1A.

27 ⁸ The release also mentioned a “Registration Guide” that the Commission had instructed its
 28 staff to prepare, 63 Fed. Reg. at 13,940, but this new guide has never been released.

1 [The Fund] will not concentrate its investments in any industry. The Fund uses the
 2 industry classifications listed below to implement this policy, and those
 3 classifications are incorporated by reference and are deemed to be part of this
 4 policy.

4 Clear incorporation-by-reference language of this kind could, if used, make the disclosed industry
 5 classifications part of the fund’s concentration “policy” for the purposes of sections 8(b)(1) and
 6 13(a)(3).

7 On the other hand, a concentration policy like the YieldPlus Fund’s that *lacks* similar
 8 express incorporation-by-reference language should *not* be read to incorporate industry
 9 classifications that the fund discloses elsewhere in its registration statement. Any other result
 10 would violate SEC regulations, which state that a fund shall be deemed to have incorporated by
 11 reference material contained elsewhere in its registration statement only if it includes an “express
 12 statement” of incorporation that “clearly identifie[s]” the material incorporated. 17 C.F.R. §
 13 270.8b-23(c). In fact, this regulation requires that the “express statement . . . be made at the
 14 particular place in the registration statement or report where the information is required.” *Id.* As
 15 discussed above, Form N-1A requires disclosure of fundamental policies in Item 16(c). *See supra*
 16 at 3. Thus for an implementing method or standard to be incorporated into a fundamental policy,
 17 the language of incorporation must be express *and* stated in Item 16(c) – the particular place in a
 18 fund’s SAI where fundamental policies are disclosed.⁹

19 In short, the relevant SEC guidance and the statutes make clear that an industry
 20 classification can only be incorporated by reference into a concentration policy if a fund
 21 affirmatively chooses to alter what otherwise would be the regular practice and expresses that
 22 decision explicitly and precisely. This is consistent with more general legal principles requiring
 23 clear incorporation language as a necessary predicate for concluding that the fund’s Board has in

24 ⁹ Importantly in this case, the YieldPlus Fund has no such incorporation in its statement of
 25 the Fund’s concentration policy, which was contained, with the other fundamental policies,
 26 in the Fund’s SAI under the section heading “Investment Limitation”. *See* YieldPlus
 27 Fund November 2005 SAI at 40; YieldPlus Fund September 2006 SAI at 40. Instead the
 28 YieldPlus Fund’s discussion of industry classification was found in a separate section
 required by Item 16(b) of Form N-1A, entitled “Investments, Risks, and Limitations”. *Id.*
 at 7; *id.* at 8. Under that heading, the Fund explained that “[t]he following descriptions of
 investment securities, risks and limitations supplement those set forth in the prospectus
 and may be changed without shareholder approval unless otherwise noted.” *Id.*

1 fact voluntarily given up its discretion over this area of fund policy. *Cf. Precision Pine & Timber,*
2 *Inc. v. United States*, --- F.3d ---, 2010 WL 569733, at *7 (Fed. Cir. Feb. 19, 2010)(requiring
3 “clear and express language of incorporation, which unambiguously communicates that the
4 purpose is to incorporate the referenced material,” before imposing an obligation on a party to an
5 agreement). This body of law teaches that to rely on vague or ambiguous language as a basis for
6 implying that a fund incorporated its industry classification into its concentration policy could
7 easily thwart the will of the fund’s Board, the entity entrusted by Congress to make this
8 determination, in the best interests of shareholders.

9 *Lapidus v. Hecht*, No. C 98-3130 MMC, 2002 WL 1034042 (N.D. Cal. May 17, 2002),
10 illustrates this point quite well. There, the fund disclosed a “fundamental” policy of “not . . .
11 mak[ing] short sales . . . except as required in connection with permissible short selling and
12 leverage activities as described elsewhere in this Prospectus.” *Id.* at *4. The prospectus also said
13 that the Fund would not sell securities short “if immediately after and as a result of the sale, the
14 value of all securities sold short by the Fund exceeds 25% of its total assets.” *Id.* at *3. Later, the
15 fund filed a prospectus supplement that raised the 25% limit to 40%. *Id.* Plaintiffs alleged that
16 the 25% limit was “incorporated” into the fundamental policy on short sales, and thus raising the
17 limit without shareholder approval violated section 13(a)(3). *Id.* The court rejected this claim
18 because there was “no language . . . purporting to incorporate a given percentage limitation” into
19 the fundamental policy. *Id.* at *4.

20 In sum, under the first category of section 13(a)(3), a fund’s Board has the discretion to
21 change a previously disclosed industry classification *unless* that classification has been explicitly
22 and clearly incorporated by reference into the fund’s section 8(b)(1) concentration policy.

23 **B. An Industry Classification Is Covered By The Second And Third Categories**
24 **Of Section 13(a)(3) Only If The Fund “Explicitly Labels” It As Fundamental**
25 **Or Changeable Only By Shareholder Vote.**

26 The second and third categories in section 13(a)(3) can be dealt with together because
27 they both involve policies that a fund voluntarily chooses to make changeable only by
28

1 shareholder vote.¹⁰ The policies covered by these two categories are straightforward. As the
 2 court explained in *In re Alliance North American Government Income Trust, Inc. Securities*
 3 *Litigation*, No. 95 Civ. (LMM), 1996 WL 551732, at *6 (S.D.N.Y. Sept. 27, 1996), if a fund's
 4 registration statement "explicitly label[s]" a policy as fundamental or affirmatively states that it is
 5 changeable only if authorized by shareholder vote, then section 13(a)(3) applies to that policy.
 6 On the other hand, if the registration statement is either (1) silent about whether a stated policy is
 7 "fundamental" or (2) states that the policy is *not* "fundamental" or is "changeable *without* a
 8 shareholder vote" (or uses similar language), then section 13(a)(3) does not apply to that policy.
 9 *See id.* Thus, under the second and third categories of section 13(a)(3), a fund may change a
 10 previously disclosed industry classification without shareholder approval *unless* its registration
 11 statement "explicitly labels" that classification a "fundamental" policy or states that the
 12 classification can only be changed with shareholder approval.

13 **C. Mutual Fund Boards Have Discretion To Change Industry Classifications**
 14 **That Do Not Fall Into Any Of Section 13(a)(3)'s Three Categories.**

15 If an industry classification does not fall into any of section 13(a)(3)'s three categories,
 16 then section 13(a)(3) does not apply and the fund's Board retains the discretion to change the
 17 classification without shareholder approval. That is why cases like *In re Alliance*, *Sheppard*,
 18 *Karpus*, and *Lapidus* hold that a mutual fund does not violate section 13(a)(3) by changing a
 19 previously disclosed policy that it has not "explicitly labeled" as "fundamental".¹¹

20 ¹⁰ Sections 8(b) and 13(a)(3) were amended in 1970. 15 U.S.C. § 80a-8(b). 13(a)(3). The
 21 original versions of these sections did not refer to policies "changeable only if authorized
 22 by shareholder vote." Instead, the SEC took the position that a policy "changeable only if
 23 authorized by shareholder vote" was a "fundamental" policy under the statute.
 24 Nevertheless, at least one district court disagreed and concluded that section 13(a)(3) did
 25 not prevent a fund from deviating from a policy that it labeled both non-fundamental *and*
 26 changeable only by a shareholder vote. *See Green v. Brown*, 276 F. Supp. 753, 756
 27 (S.D.N.Y. 1967). In 1970, Congress added section 8(b)(2) and amended section 13(a)(3)
 28 "to make it clear that deviation from an investment policy which is changeable only by
 shareholder vote constitutes a violation of section 13." Investment Company
 Amendments Act of 1970, H.R. Rep. No. 91-1382 at 19, 91st Cong. 2d Sess. (1970).

26 ¹¹ In their brief, Plaintiffs suggest that these cases and others like them have nothing relevant
 27 to say about this issue because they do not specifically address a change to a "provision"
 28 that is "linked" to a fund's concentration policy. Plaintiffs' Br. at 18. But nothing in
 section 13(a)(3) even hints that changes to disclosures that are "linked" to a concentration
 policy should be treated any differently than disclosures that are "linked" to the

1 Of course, even if a fund’s industry classifications are “non-fundamental,” the fund’s
2 Board does not have unfettered discretion to adopt whatever classifications it wishes. Mutual
3 funds are organized under state law, which imposes on fund Boards the same fiduciary duties of
4 due care and loyalty that apply to the directors of an ordinary corporation. *See, e.g., Lutz v. Boas*,
5 171 A.2d 381, 395 (Del. Ch. 1961). The Investment Company Act strengthens these traditional
6 safeguards by imposing extensive additional substantive requirements on funds and by requiring
7 at least 40% of a fund’s Board to be independent of the investment adviser. *See generally*
8 Thomas Lee Hazen, *The Law of Securities Regulation* § 20.6 (6th ed.). In practice, independent
9 directors comprise an overwhelming majority (75% or more) on most fund Boards. *See Overview*
10 *of Fund Governance Practices, 1994-2008* at 6, available at
11 http://www.ici.org/pdf/pub_09_fund_governance.pdf. Under state law and the ICA, these
12 majority-independent Boards must act in the best interests of shareholders, including when they
13 consider modifying a fund’s industry classifications. *See, e.g., William Meade Fletcher*, 3
14 *Fletcher Cyc. of the Law of Corp.* § 837.60 (“The duty of loyalty mandates that the best interests
15 of the corporation and its shareholders take precedence . . .”).

16 Moreover, the SEC staff has made clear that a fund’s industry classifications must be
17 reasonable. To be sure, a reasonableness test creates broad discretion, but that is because the
18 concept of an “industry” is inherently vague and open to numerous acceptable interpretations. As
19 the SEC staff has acknowledged, “[t]here is no clear standard to determine what constitutes an
20 ‘industry,’ much less a ‘group of industries.’” *Protecting Investors: A Half Century of Investment*
21 *Company Regulation, Investment Company Governance*, at 281 n.103 (SEC May 1992).
22 Presumably, that is why the SEC has not imposed a one-size-fits-all industry classification list on
23 all funds, but instead allows funds to select their own reasonable classifications.

24
25
26 “fundamental” policies at issue in those cases. Likewise, no SEC guidance suggests that
27 changes to a previously disclosed approach to implementing a concentration policy should
28 be treated any differently than changes to previously disclosed methods of implementing
“fundamental” policies.

1 **D. Congress Purposely Gave Fund Boards Discretion To Choose Which Policies, If Any, Should Be Deemed “Fundamental.”**

2
3 Allowing Boards to change industry classifications is not an anomalous result or a
4 “loophole” in the Investment Company Act. Rather, it is simply an example of the flexibility that
5 Congress deliberately built into the statute. Specifically, the Investment Company Act legislation
6 originally proposed in Congress would have given the SEC the authority to “designate those
7 investment and management policies which are fundamental,” and thus changeable only with
8 shareholder approval. *A Bill to Provide for the Registration and Regulation of Investment*
9 *Companies*, S. 3580, 76th Cong., §13(b) (1940).¹² After extensive hearings, Congress dropped
10 this provision. In its place, Congress set out eight specific policies that could only be changed by
11 a shareholder vote – namely the eight policies that funds must disclose under section 8(b)(1) –
12 and then gave funds the option of choosing which additional policies, if any, they deemed
13 “fundamental”. This drafting history makes clear that a fund’s ability to choose whether to make
14 its industry classifications changeable only by a shareholder vote is not a mere quirk in the statute
15 or a legislative oversight, but rather a deliberate policy choice made by Congress.

16 This specific policy choice also gives meaning to the broad, general policy goals laid out
17 in section 1 of the Act, which Plaintiffs rely on extensively in their brief. For example, section 1
18 explains that the interests of investors are “adversely affected . . . when investment companies . . .
19 change the character of their business . . . without the consent of their security holders.” 15 U.S.C.
20 § 80a-1(b)(6). Sections 8(b) and 13(a) make clear that the “character” of a mutual fund’s
21 business referred to in this section includes the eight specific policies Congress required funds to
22 disclose and any other policy the fund told investors was “fundamental” or changeable only with
23 shareholder consent. On the other hand, any policy that is *not* expressly covered by sections
24 8(b)(1) and 13(a), and not deemed to be fundamental by the fund itself, cannot otherwise be
25 deemed part of the “character” of the fund’s business, and thus can be changed without the

26 ¹² The complete text of the bill is reprinted in *A Bill to Provide for the Registration and*
27 *Regulation of Investment Companies, and for Other Purposes: Hearings Before a*
28 *Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong., Part I*
at 1-32 (1940).

1 consent of the fund’s shareholders. Plaintiffs’ flawed effort to read something more into the
 2 vague language of section 1 is nothing more than an impermissible attempt to use a general
 3 statement of policy to *override* a specific policy choice Congress made, as embodied in sections
 4 8(b) and 13(a). *See, e.g., Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 220
 5 (2002)(“[V]ague notions of a statute’s basic purpose are . . . inadequate to overcome the words of
 6 its text regarding the *specific* issue under consideration.”) (quotation marks omitted; emphasis in
 7 original); *Reeves v. Astrue*, 526 F.3d 732, 737 (11th Cir. 2008)(“[W]e cannot use Congress’s
 8 general statements of findings and purpose to override the plain meaning of specific provisions of
 9 the Act.”).

10 **E. Protecting Board Discretion Regarding The Implementation Of Fundamental**
 11 **Policies Is In The Best Interests Of Shareholders.**

12 Preserving Board discretion regarding the types of non-fundamental policies that are
 13 necessary to implement fundamental policies is in shareholders’ best interests. Like the founding
 14 documents of many organizations, a mutual fund’s “fundamental” policies often are phrased in
 15 broad terms that require interpretation and the exercise of judgment before they can be applied to
 16 a specific set of facts. *See, e.g., SEC No-Action Letter to the Investment Company Institute at 10,*
 17 *1996 WL 282576, at *7 (May 9, 1996)*(explaining that a mutual fund’s Board must exercise its
 18 discretion to determine whether the fund’s fundamental policies permit compliance with
 19 amendments to SEC Rule 2a-7). Moreover, in the world of investment management, the facts
 20 themselves may change rapidly as markets evolve to reveal new types of securities and new
 21 investment strategies, while exposing the limits and shortcomings of old strategies. Thus, a
 22 mutual fund Board must maintain the discretion necessary to take advantage of new opportunities
 23 that are consistent with the interests of shareholders and the fund’s truly “fundamental” policies.

24 Indeed, these precise concerns led the SEC to modify a proposed rule regarding mutual
 25 fund names. Under the proposed rule, any fund with a name suggesting that the fund focuses its
 26 investments in a particular type of investment would have been required to adopt a “fundamental”
 27 policy mandating that the fund invest at least 80% of its assets in that type of investment. *See*
 28 *Proposed Rule, Investment Company Names*, 62 Fed. Reg. 10,955, 10,957 (Mar. 10, 1997).

1 Numerous commentors objected to the proposal, explaining that, among other things, it would be
2 “too burdensome for investment companies, constraining their ability to respond efficiently to
3 market events or to new regulatory requirements[.]” Final Rule, *Investment Company Names*, 66
4 Fed. Reg. 8,509, 8,511 (Feb. 1, 2001). “[P]ersuaded” by these comments, the SEC modified the
5 rule so that instead of adopting the 80% rule as a fundamental policy, a fund could adopt it as a
6 non-fundamental policy subject to change on 60-days notice to shareholders. *Id.* Thus, the SEC
7 has recognized that it is appropriate to preserve Board discretion over decisions as important as
8 modifying the basic investment policies underlying a fund’s name, decisions that plainly are more
9 important to most investors than revisions to a fund’s industry classifications.

10 The ability to interpret fundamental policies also plays an important part in a Board’s
11 ability to fulfill its role as a “watchdog” over the investment adviser who manages the fund’s day-
12 to-day operations. *Burks v. Lasker*, 441 U.S. 471, 484 (1979); *see also Fund Director’s*
13 *Guidebook*, 52 Bus. Law. 229, 259 (1996)(“Although fund directors are not expected to play an
14 active role in managing a fund’s investments, they do retain responsibility to oversee generally
15 the fund’s investment performance and to monitor investment practices.”). One way a fund
16 Board can limit the discretion of the investment adviser is to establish specific investment
17 standards, such as an industry classification that categorizes the fund’s assets in a reasonable way,
18 in light of current markets and current experiences with particular securities. Over time, as
19 market conditions change, the adviser learns more about current or new securities, or other
20 aspects of the fund’s portfolio evolve, the original classification may no longer be optimal for
21 investors, in the judgment of the Board. Absent the freedom to make reasonable changes to those
22 classifications, Boards likely would be much less willing to enact such restrictions in the first
23 place.¹³

24
25 ¹³ To the extent that there is a policy argument against Board discretion in these areas, it
26 arises from the need to protect investors who read and relied upon previously disclosed
27 non-fundamental policies. But this reliance interest is adequately addressed by timely
28 disclosure of current industry classifications, as occurred here, irrespective of whether
those policies were labeled “fundamental”.

1 **F. The Yieldplus Fund's Board Did Not Give Up Its Discretion To Change**
 2 **Industry Classifications Without Shareholder Approval.**

3 It is, of course, the prerogative of this Court to apply the well-settled principles discussed
 4 above to the particular facts of this case. In light of the undisputed facts, however, the method for
 5 classifying mortgage-backed securities contained in the YieldPlus Fund's November 2005 SAI
 6 does not fall within any of section 13(a)(3)'s three exceptions to the general rule that a fund may
 7 change its industry classifications without shareholder approval.

8 First, the classification was not incorporated by reference into the Fund's concentration
 9 policy, which was, in form, essentially identical to the standard model policy described by the
 10 SEC. *See, supra* at 5. Second, the Fund did not "explicitly label" the classification as
 11 "fundamental." Third, the Fund did not say that the classification was changeable only with
 12 shareholder approval. Instead, the Fund placed the classification among a set of policies in the
 13 SAI (not the prospectus) that the Fund expressly stated could be changed *without* shareholder
 14 approval. *See* YieldPlus Fund November 2005 SAI at 7.

15 Accordingly, section 13(a)(3) does not apply to the industry classification, and the Fund's
 16 Board had the discretion to change it without first obtaining shareholder approval.

17
 18 Dated: March 18, 2010

Respectfully submitted,

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