

June 2006

The following summarizes recent *Legal Developments of Note* affecting the mutual fund/investment management industry:

Mutual Funds Required to Comply with Suspicious Activity Report ("SAR") Filing Requirements

The Department of the Treasury's Financial Crisis Enforcement Network ("FinCEN") has adopted a rule that requires mutual funds to report "suspicious transactions," which are broadly defined to include transactions a financial institution has reason to suspect may be involved with illegal activity, including transactions conducted as a means to facilitate or disguise such activity. The new rule is part of the anti-money laundering reporting requirements established by FinCEN pursuant to the Bank Secrecy Act and extends to mutual funds requirements that have been applicable to banks for many years. The SAR reporting requirements will apply to transactions occurring after October 31, 2006.

SEC Sanctions Adviser for Compliance Rule Violations

The SEC announced that it had reached a settlement with an investment adviser in connection with violations of the antifraud provisions of the Investment Advisers Act and the failure of the adviser to adopt written compliance procedures as required by Rule 206(4)-7 under the Act (the "Compliance Rule"). Specifically, the SEC found that the adviser: (i) failed to adopt written policies and procedures relating to client communications, such as responses to requests for proposals ("RFPs"), (ii) repeatedly made false statements about its compliance record in RFPs, and (iii) continued to make such false statements even after the SEC examiners had notified the adviser that the false statements were a compliance deficiency. In settling what is the first enforcement action in which an adviser has been expressly cited for Compliance Rule violations, the adviser agreed to pay fines totaling \$65,000, and to hire an Independent Consultant (acceptable to the SEC staff) to conduct quarterly reviews of the adviser's compliance with respect to its client communications. The Independent Consultant is required to file quarterly status reports with the SEC and the adviser for a period of two years.

ICI Distributes Sub-Adviser Due Diligence Questionnaire and Certification Letter

The ICI has distributed a sample form of questionnaire and certification letter intended to assist its members in conducting sub-adviser due diligence reviews. These forms were developed by a working group comprised of membership of the ICI, the Investment Adviser Association and legal counsel to independent directors. The questionnaire reflects many of the requirements of the Compliance Rule with emphasis on a review of the sub-adviser's compliance policies, procedures, violations, assessments and testing.

Revenue Ruling 2006-31 Extends Effective Date and Clarifies Scope of Prior IRS Guidance

Released earlier this year, Revenue Ruling 2006-1 called into question the status of income derived from commodity-linked derivative products under the so-called "good income test," which is one of several tests that investment companies must satisfy to qualify for the special federal tax treatment accorded to regulated investment companies. Revenue Ruling 2006-31 extends the effective date of the prior ruling to September 31, 2006 and clarifies that, although the prior ruling was intended to address income derived from most commodity-linked derivative products, it was not intended to address income derived from certain commodity-linked structured notes. Revenue Ruling 2006-31 does not elaborate on the types of commodity-linked structured notes that are excluded from the scope of the prior ruling.

For further information, please contact your Ropes & Gray attorney.

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