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

SEC Adopts Amendments to Redemption Fee Rule and Extends Compliance Date for Financial Intermediary Agreements

Investment Company Act Rule 22c-2 requires that all funds execute shareholder information agreements with each of their financial intermediaries that require those intermediaries to provide the fund with information relevant to determining the extent of possible market timing activity. This past February, the SEC proposed amendments to Rule 22c-2, which were designed to clarify the definition of "financial intermediary" and reduce the number of intermediaries from which agreements were required to be obtained. On September 25th the Commission voted to adopt the proposed amendments, with minor changes, and also extended the compliance date for the shareholder information agreement portion of the rule from October 16th to April 16, 2007.

Fund Administrator Agrees to Pay $21 million to Settle SEC Proceeding

The SEC announced on September 26th that it had entered into a Settlement Order (the "Order") with a fund administrator which entered into undisclosed fund marketing support agreements with advisers of various funds. The Order states that pursuant to the side agreements, the administrator agreed to rebate a portion of its fund administration fees to the fund advisers in exchange for the advisers making favorable recommendations to the funds' boards of trustees concerning the renewal of the administration agreement. As discussed in the Order, the fund administrator was found to have "aided and abetted the advisers' improper use of fund assets for marketing and other expenses incurred by the advisers." The Order emphasizes that the side agreements were not disclosed to the trustees of the funds, and that what disclosures were made to the funds' shareholders were incomplete and misleading. The central theme of the Order is that the fees paid to the administrator were fraudulently "inflated" by the amount of the payments that the administrator paid to, or at the behest of, the advisers.

SEC Investment Management Division Director Discusses Priorities

In a speech delivered on September 25th, as part of an industry compliance conference, Andrew J. Donohue, the Director of the SEC's Division of Investment Management, highlighted the initiatives that the Division is currently focusing on.

According to Mr. Donohue, one of the "largest and most consequential undertakings" of the SEC at this time is the Investment Adviser/Broker Dealer Study. This study will be undertaken pursuant to a contract which has just been awarded to an independent third party and is intended to provide the Commission and its staff with data on how the broker-dealer and investment advisory regulatory schemes impact firms and investors.

Other major initiatives mentioned in the speech include:

- Modernizing the books and records requirements
- Re-proposal of a revised form of Form ADV-Part II (the client disclosure portion of the investment adviser registration form)
- Further guidance regarding Soft Dollars and Best Execution
- Promulgation of a new anti-fraud rule that would have the effect of "looking through" a hedge fund to its investors

Financial Accounting Standards Board Issues New Standards for Fair Value Accounting

The Financial Accounting Standards Board ("FASB") recently issued FASB Statement No. 157 ("FASB 157"), which consolidates into one statement the definition of the term "fair value" as used in generally accepted accounting principles ("GAAP"). This guidance was previously dispersed among many accounting pronouncements that require fair value determinations in various contexts, and FASB 157 does not create any new situations for which a fair value determination must be made. FASB 157 emphasizes that fair value is a market-based measurement of the amount that would be received upon the sale of the asset (or paid to transfer the liability) (*i.e.*, an exit price) and not the price that would be paid to acquire the asset (or received to assume the liability) (*i.e.*, an entry price).

Court Grants Summary Judgment in Favor of Insurance Company in "Reverse Market Timing" Case

New York Life was awarded summary judgment dismissing a "reverse market timing" case, by the United Sates District Court for Massachusetts. Plaintiff Barry Linton sued New York Life, asserting that he had the right to make telephonic trades designed to market time various funds that were investment options under the variable life insurance policy he had purchased from New York Life. After allowing Plaintiff to execute trades via telephone instructions in the underlying mutual funds of the variable life insurance policy for several years, New York Life identified Plaintiff as a market timer and required him to place all trade orders in writing. The Plaintiff sued for breach of contract, misrepresentation, breach of an implied covenant of good faith and fair dealing, unjust enrichment and violation of the Massachusetts Unfair Trade Practices Act.

As a matter of interpretation of the terms of the insurance contract, the court found that the variable life insurance policy did not give Plaintiff the right to execute trades by telephone, and that New York Life had the right to make changes to its administrative practices. The Plaintiff also made various misrepresentation claims based upon alleged oral assurances he received from the insurance agent that the Plaintiff would be able to give trade instructions by telephone. The court found that the Plaintiff could only recover for his actual losses suffered as a result of his reliance on the alleged misrepresentations. Since the Plaintiff experienced a 201% return before New York Life revoked the Plaintiff's privilege to execute trades by telephone, the Plaintiff could show no damages, other than his alleged "lost profits," which are not recoverable under a claim based on a misrepresentation.

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

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