ROPES & GRAY

INVESTMENT MANAGEMENT UPDATE

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

NYSE Files Proposal with SEC to Change Proxy Rule Regarding Broker Voting on Election of Directors

The New York Stock Exchange ("NYSE") has filed a proposal to change NYSE Rule 452 which allows brokers to vote on "routine" shareholder proposals if the beneficial owner of the stock (i.e., the broker's client) does not provide instructions to the broker at least 10 days before the scheduled meeting. Currently, Rule 452.11 lists 18 examples of "non-routine" matters which brokers are prohibited from voting on without client instructions. The amendment proposed by NYSE adds the election of directors to this list of non-routine matters. In its filing, the NYSE notes that the proposed change could "significantly impact the director election process" and that it is likely to increase the costs of uncontested elections. The NYSE determined that these increased costs were more than offset by the benefits to be obtained by the new rule, citing better corporate governance and transparency in the election process as benefits that will result from the proposed rule change.

NASD Amends Rule 2340 to Require Brokers to Include a Prompt Reporting Statement in Client Account Statements

Acting on a recommendation in a May, 2001 report issued by the Government Accountability Office ("GAO") (formerly known as the U.S. General Accounting Office), the NASD has amended Rule 2340 to require general securities firms to include in monthly client account statements a statement advising the client to promptly report to the broker any inaccuracy or discrepancy in the client's account. The statement must also advise the client that any oral communications should be reconfirmed in writing to further protect the client's rights under the Securities Investor Protection Act ("SIPA"). This statement is required to be included because, in the event a brokerage firm goes into liquidation, the SIPC and the insolvency trustee generally will assume that the brokerage firm's records are accurate and the burden would be on the client to prove otherwise. The NASD notes that Rule 2340, as amended, does not affect the client's rights to raise concerns about the accuracy of account statements at any time, including during the course of an SIPC proceeding.

SEC Adopts New Investment Company Act Rules Expanding the Definition of "Eligible Portfolio Company"

Business Development Companies ("BDCs") are closed-end investment companies which are subject to fewer constraints under the Investment Company Act in order to increase the flow of capital to small, developing or financially troubled businesses. BDCs are required to invest at least 70% of their assets in certain categories of investments, most significantly, "eligible portfolio companies" as defined in Section 2(a)(46) of the Investment Company Act. "Eligible portfolio companies" include, among other things, domestic non-investment companies that do not have a class of securities that are marginable under the Federal Reserve Board's margin rules. Changes to the Federal Reserve Board's margin rules in 1998 had the effect of increasing the types of securities that could be considered marginable securities and, as a result, potentially reducing the number of eligible portfolio companies. In response, in 2004 the SEC proposed rules expanding the definition of "eligible portfolio company," two of which were recently adopted and one of which was reproposed for comment. New Rule 2a-46 defines "eligible portfolio company" to include all domestic non-investment companies that do not have a class of securities listed on a national securities exchange. New Rule 55a-1 permits a BDC to include in its 70% "basket" follow-on investments in a company that was an eligible portfolio company at the time of the BDCs initial investment but is no longer an eligible portfolio company because it does not meet the requirements of Rule 2a-46, provided certain ownership thresholds and other conditions are satisfied. The SEC also reproposed Rule 2a-

46(b), which would include as eligible portfolio companies certain exchange listed companies provided certain public flotation or market capitalization tests are met. Comments on proposed Rule 2a-46(b) are due by January 2, 2007.

ING Settles New York Attorney General Investigation Into Its Marketing of 403(b) Variable Annuity Products

On October 10, 2006, ING Life Insurance and Annuity Company ("ING") and the Office of the Attorney General of the State of New York (the "OAG") entered into an Assurance of Discontinuance settlement agreement (the "Settlement Agreement") regarding certain insurance and financial planning products marketed by ING (and its predecessor, Aetna Insurance Company) to members of the New York State United Teachers Union (the "Union"). According to the Settlement Agreement, the conduct under investigation began in 1988, when Aetna obtained the "exclusive endorsement" of the New York State United Teachers Benefit Trust (the "Trust"), a trust established by the Union to manage benefits for Union members. In consideration for the Trust's "exclusive endorsement" of a 403(b) product called "Opportunity Plus," Aetna agreed to pay the Trust substantial sums as an "expense reimbursement." In addition to using the Trust's exclusive endorsement in connection with Opportunity Plus, ING began to make use of this endorsement in marketing various other financial products to Union members, such as financial planning advice. As the sales of ING's products to Union members continued to grow, the Trust employed six financial services coordinators to act as liaison between ING and the Trust with respect to the ING programs and services offered to Union members. Although the coordinators held themselves out as Trust employees whose role was to work solely on behalf of the Trust and in the best interests of Union members, ING in fact reimbursed the Trust for the coordinators' salaries (the Trust paid for their employee benefits). The coordinators also participated in significant marketing activities conducted by ING, such as accompanying ING sales agents to conferences where ING marketed its products.

The OAG found that INGs failure to properly disclose its "close working relationship" with the Trust constituted a "deception or concealment in the purchase, sale or promotion of securities" in violation of New York State law. Under the Settlement Agreement, ING agreed to pay $30,000,000 in restitution to former and current Union members who participated in Opportunity Plus at any point between January 1, 2001 and June 30, 2006. Additionally, within six months after the date of the Settlement Agreement and for at least five years thereafter, ING must attach a separate disclosure document to the offering materials used in connection with various retirement products offered by ING.

SEC Expands Probe into Payments by Mutual Fund Administrator to Fund Advisers

In last month's Update, we reported on the settlement between the SEC and a fund administrator concerning service fees charged by the administrator that the SEC determined were "inflated" to the extent they were used to pay marketing expenses and other costs of the various fund advisers. According to published news reports, the SEC is following up on this settlement by sending information request letters to a number of fund advisers asking them to provide details about their involvement with the conduct of the fund administrator.

ICI Distributes New Model Financial Intermediary Agreement to Reflect Final SEC Redemption Fee Rule Requirements

The ICI has circulated revised model contractual clauses to reflect the recent amendments to SEC Rule 22c-2. Among other things, the new amendments incorporate the definition of financial intermediary and clarify the duty of a financial intermediary that has an account with the fund (a "direct intermediary") to obtain information from its customers who are also financial intermediaries (an "indirect intermediary").

IRS Revenue Ruling Clarifies Treatment of "Excess Inclusion" Income

The Internal Revenue Service recently released Revenue Ruling 2006-58 and Notice 2006-97 that, among other things, clarify the tax reporting, payment and withholding requirements for regulated investment companies that invest in certain real estate investment trusts ("REITs") and residual interests in real estate mortgage investment conduits. These types of investments can give rise to a special category of income (so-called "excess inclusion income") which would be unrelated business taxable income ("UBTI") in the hands of certain tax-exempt investors (other than charitable remainder trusts) and would be subject to the maximum rate of withholding if paid to non-U.S. investors. Further details regarding scope and effect of this Revenue Ruling will be discussed in an upcoming Ropes & Gray Client Alert.

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