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

NASD and NYSE Announce Plan to Consolidate Self-Regulatory Organizations

On November 28th, NASD and NYSE Group announced that they had signed a letter of intent to enter into an agreement consolidating their two separate self-regulatory organizations ("SRO's") into a single new SRO. NASD currently regulates more than 5,100 securities firms in the United States. Of this total, almost 200 firms, including most of the industry's largest, are also members of NYSE and therefore are regulated by both organizations. As a result of the consolidation, those regulated firms dually registered with NASD and NYSE will ultimately be subject to one set of rules created and enforced by the new single SRO. The transaction is subject to completion of definitive documentation, an NASD member vote, and approval by the SEC.

European Commission Publishes White Paper on Enhancing the Single Market Framework for Investment Funds

In 1985, the European Commission adopted a Directive which created the legal framework for Undertakings for Collective Investment in Transferable Securities ("UCITS"). The UCITS Directive lays out the rules for governance, investment restrictions and operation of an investment fund that is eligible for a "passport," which allows it to be marketed to the public throughout the EU. After extensive study, the Commission issued a "White Paper" on the European single market framework for investment funds which reports that certain "core elements" of the UCITS Directive are not functioning effectively, and that these inefficiencies are being reflected in higher costs and lower returns to investors. Specifically, the White Paper cited the following shortcomings of the existing legislative framework as areas of concern:

- Failure of product passport. The procedures for cross border marketing take too long and are too expensive due to excessive local regulatory interference.
- Substandard investor disclosures. The simplified prospectus does not help investors make sound investment decisions.
- Proliferation of small inefficient funds. The Directive provides no mechanisms to facilitate the consolidation of funds, in particular due to the different tax laws in the various Member States.
- Passport does not permit functional or geographic specialization. Under the UCITS Directive, only the fund can be passported. As a result, all fund administrative and other "value chain" activities must still be located in one Member State.

The White Paper goes on to discuss the causes of these shortcomings and outlines a package of legislative and non-legislative actions that the Commission intends to pursue to address these problems over the next few years.

SEC Provides Additional Guidance on Mutual Fund Cross Trades.

In a recent no-action letter requested by Federated Municipal Funds, the staff of the SEC stated that it would not recommend enforcement action under Section 17(a) of the Investment Company Act if the funds used a Standard & Poors pricing service in connection with certain Rule 17a-7 transactions (i.e., cross trades of municipal securities for

which market quotations are not readily available, between funds which are affiliated by reason of having a common investment adviser).

Significantly, the SEC staff went beyond granting the no-action relief specifically requested, and provided more general guidance as to its views on an adviser's duty to obtain best execution and its duty of loyalty in the context of Rule 17a-7 transactions. The no-action letter stated that if the selling fund can obtain greater proceeds by selling the security in the market, rather than by selling it to an affiliated fund, the adviser has a duty to sell the security in the market and not engage in a cross-trade. The same principle applies to the buying fund as well, and an adviser should not buy a security in a Rule 17a-7 transaction that it could buy at a lower price in the market. The staff also pointed out that, consistent with an investment adviser's duty of loyalty, an adviser should not cause funds to enter into a Rule 17a-7 transaction unless the transaction would be in the best interests of both funds. The no-action letter also indicates that the Nasdaq Official Closing Price ("NOCP") is another pricing methodology that is appropriate to use for Rule 17a-7 transactions involving "NMS Stock" as defined in SEC Regulation NMS.

Proposed FASB Staff Position Extends Consolidation FIN 46(R) Exception to Unregistered Funds.

In 2003, following the accounting abuses which led to the Enron scandal, the Financial Accounting Standards Board ("FASB") proposed new standards governing when a partnership's financial statements must be consolidated into the financial statements of the general partner of the partnership. This guidance, known as FIN 46(R), contained an exemption from the consolidation requirements for entities subject to SEC Regulation S-X, Rule 6-03(d)(1), which applies to registered funds.

Paragraph 36 of FIN 46(R) contained an indefinite deferral of its effective date for unregistered funds that follow the AICPA Investment Company Audit Guide until such time as the AICPA issued a Statement of Position ("SOP") to clarify how FIN 46(R) should be applied in this context. The AICPA has recently finalized the SOP, and it is expected to be published in the near future. The new SOP will provide guidance as to the circumstances in which an unregistered fund is entitled to utilize the specialized accounting treatment set forth in the Guide. The staff of the FASB has recently proposed a FASB Staff Position ("FSP") which will confirm that unregistered entities within the scope of the Guide will be exempt from the consolidation requirements of FIN 46.

FinCEN FAQ Offers Guidance to Mutual Funds on New SAR Reporting Requirements.

The Department of the Treasury Financial Crimes Enforcement Network ("FinCEN") has published responses to a lengthy list of "Frequently Asked Questions" ("FAQ") to provide interpretive guidance with respect to the suspicious activity report ("SAR") filing requirements which became applicable to registered investment companies on October 31, 2006.

In addition to other issues, the FAQ answers a number of questions concerning the non-disclosure provisions of 31 CFR 103.15(d), which generally prohibit a fund from disclosing any information concerning a SAR filing to any person involved in the transaction in question. With respect to whether a fund may share information concerning a SAR filing with an investment adviser that "controls" the fund, the FAQ indicates that FinCEN carefully considered this issue, balancing the need to protect SAR confidentiality with the "legitimate need for investment advisers to be able to implement enterprise-wide risk management and compliance functions over all of the mutual funds they control."

After balancing these considerations, FinCEN determined that a U.S. mutual fund may share SAR information with the investment adviser that controls the fund, whether domestic or foreign, subject to certain conditions. As the FAQ notes:

There may be circumstances under which a mutual fund would be liable for direct or indirect disclosure of a Suspicious Activity Report by the investment adviser that controls the fund, or the fact that a Suspicious Activity Report had been filed. Therefore, the mutual fund, as part of its anti-money laundering program, must have written confidentiality agreements or arrangements in place specifying that the investment adviser must protect the confidentiality of the Suspicious Activity Report through appropriate internal controls.

The FAQ also notes that certain additional considerations may apply with regard to disclosures to non-U.S. entities.

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