The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

NYSE Advises Members to Disclose Risks of Voting Loss and Dividend Income Status to Margin Account Customers

The NYSE recently issued guidance advising its members to provide effective disclosure to customers regarding the possible loss of proxy voting rights for securities held in margin accounts. The NYSE is concerned that customers may not realize that their margin agreements grant brokers the right to hypothecate or lend shares to third parties. When such a loan is made, the right to vote the shares is also transferred to the third party. Thus, if a corporate vote is taken while the customer's shares are on loan, they may be voted by the third party in a manner which is contrary to the desires of the customer.

The NYSE also noted another risk arising in connection with margin accounts that can occur when shares are on loan past the ex-dividend date. Under federal tax laws, the dividend payments for shares that are loaned are required to be reported to the broker as ordinary income. In this situation, customers with taxable accounts will lose the benefit of the lower tax rates applicable to dividends. According to the NYSE, "good business practice compels the disclosure of these risks to the customer in plain English."

SEC Probes Affiliate Securities Lending Arrangements

In a recent speech, Gene Gohlke, the Associate Director of the SEC's Office of Compliance, Inspections and Examinations, commented on the results of an SEC sweep exam which focused on the use of affiliates in connection with the securities lending programs of certain mutual fund complexes. According to Mr. Gohlke, the exams revealed that there were a variety of conflicts of interest inherent in such arrangements which need to be closely monitored. Examples of improper practices which came to light include instances of "tipping," where the affiliate was informed of the terms submitted by other bidders so that the affiliate could submit the lowest bid; failure to monitor the securities lending returns generated by the fund's affiliate; and advantageous fee arrangements which benefited the affiliate at the expense of the funds.

Foreign Financial Intermediaries Granted Relief From Redemption Fee Rule Customer Identification Requirements

The Investment Company Institute ("ICI") recently requested a no-action letter to permit foreign financial intermediaries to provide account information based on randomly generated identifying numbers for their customers holding fund shares through a nominee account, rather than providing the customers' governmentally assigned identifying numbers (i.e., a TIN, ITIN or GII) as required by Rule 22c-2. As explained in the ICI's request, under the privacy laws of many foreign jurisdictions, foreign financial intermediaries may be prohibited from disclosing such information without the customers' consent. The ICI further indicated that obtaining such consent from thousands of customers would not be feasible for foreign financial intermediaries. The SEC responded to the ICI's request by agreeing that it would not recommend enforcement action against funds that enter into shareholder information agreements permitting <u>certain</u> foreign financial intermediaries to supply transaction information using unique identifying numbers assigned by the intermediaries. This relief is only available for accounts established before <u>January 1, 2008</u> and is limited to foreign financial intermediaries that are prohibited by applicable foreign law from sharing their customers' governmentally assigned identifying numbers without the prior affirmative consent of such customers.

Commodity Futures Trading Commission Adopts New E-Filing Rule

The Commodity Futures Trading Commission ("CFTC") recently adopted rule changes requiring electronic filing of certain regulatory notices of exemption or exclusion from registration that are currently filed in paper form by mutual funds, hedge funds and investment advisers. Notices filed on or after February 15, 2007 must comply with the new electronic filing requirements. Filing with the National Futures Association (the "NFA") is required in order to assert certain exclusions and exemptions relating to a commodity pool operator ("CPO") under Part 4 of the CFTC's regulations, including Regulation 4.5 (providing an exclusion for "other regulated persons" such as registered investment companies), Regulation 4.7 (limiting obligations of a registered CPO), and Regulations 4.13(a)(3) and 4.13(a)(4) (exempting certain hedge fund sponsors). Similarly, a filing with the NFA is currently required in order for a registered investment adviser to claim the exemption from registration as a commodity trading advisor ("CTA") under Regulation 4.14(a)(8). The amendments do not alter the filing obligations under these rules, rather only the form in which filings are submitted. Electronic filing will be required for new notices, but notices filed in paper format before the rule takes effect will not need to be refiled electronically. Notices must be submitted directly into the NFA's electronic filing system, which can be accessed through the NFA website, using a user ID and password. Firms that are registered with the CFTC as a CPO, CTA or otherwise will be able to make use of the NFA's existing Online Registration System. Unregistered firms will be required to follow a new online process for establishing an account, requesting a user ID and password, and designating authorized system users.

California Appellate Court Rules that Attorney General's State Law Claims are not Barred by Federal Law

In a recent case, the California Court of Appeals held that the National Securities Markets Improvement Act of 1996 ("NSMIA") did not prevent the attorney general from suing a fund advisor and distributor for failure to properly disclose various "shelf-space" compensation arrangements. This appeal was filed after the trial court ruled that NSMIA prohibited the attorney general from pursuing claims that the disclosures relating to the compensation arrangements contained in various federally regulated mutual fund disclosure documents were "materially false and misleading" in violation of California Corporations Code, Sections 25401 (prohibiting untrue statements of material fact) and 25216 (prohibiting manipulative, deceptive or other fraudulent schemes). NSMIA is a federal law which prohibits states from limiting or imposing any conditions upon the use of "any offering document that is prepared by or on behalf of" the issuer of a "covered security." The issue in this case revolved around whether the state law "savings clause" contained in NSMIA applied to the type of state law claims asserted by the attorney general. The court noted that the "savings clause" allows "the securities commission (or agency or officer performing like functions) of any state" to bring an action to enforce the laws of such state "with respect to fraud, deceit, or unlawful conduct by a broker or dealer, in connection with securities or securities transactions." After reviewing the legislative history, the court found that the attorney general's claims against the fund's distributor and its advisor (i.e., not the fund itself) were the types of claims that NSMIA "saved" from federal preemption, and remanded the case back to the trial court.

DOL Interim Final Rule Clarifies Requirements for Cross-Trading Policies

The Pension Protection Act of 2006 amended the Employee Retirement Income Security Act ("ERISA") by adding Section 408(b)(19), which provides for a new prohibited transaction exemption ("PTE") for transactions involving cross-trading (the purchase and sale of a security between a plan and another account managed by the same investment manager). One requirement of the new cross-trading PTE is that the investment manager must adopt, and effectuate cross-trades in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program.

On February 12, 2007, the Department of Labor issued an interim final rule establishing the content requirements for such written cross-trading policies and procedures. The rule requires that cross-trading procedures be clear, concise and written in a manner calculated to be understood by the plan fiduciary who authorizes the plan's participation in the cross-trading program. In addition, the information contained in the policy must be sufficient to permit a periodic review of any cross-trades by the compliance officer and to permit the plan fiduciary to assess the investment manager's cross-trading program. Further details about the requirements imposed by the new rule will be included in an upcoming Ropes & Gray Client Alert on this topic.

Contact Information

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