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

SEC Staff Provides Additional Guidance Regarding Hedge Clauses in Investment Advisory Agreements

A registered investment adviser requested a no-action letter from the SEC staff to permit the adviser to include a so-called "hedge clause" in its investment advisory agreements with sophisticated clients (which included clients in certain wrap-fee programs). The term "hedge clause" generally refers to a contractual provision that purports to limit an adviser's liability to its client. In a series of previous no-action letters, the SEC staff indicated that hedge clauses could violate the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), because such clauses may be likely to lead an investor to believe he has waived any right of action he may have against the adviser. Section 215 of the Advisers Act prohibits including in an advisory agreement any provision which waives compliance with any provision of the Advisers Act or the rules, regulations or orders thereunder. After considering various facts and circumstances described in the no-action request, the SEC staff concluded that, as a matter of policy, it would "state no position" as to whether the use of any specific hedge clause or non-waiver disclosure would be misleading to a particular client due to the fact-specific nature of such an inquiry. However, the SEC staff indicated that the use of a hedge clause, coupled with appropriate non-waiver disclosure, would not per se violate Section 206(1) and 206(2) of the Advisers Act. In assessing the appropriateness of a hedge clause in particular circumstances, the SEC staff noted that it would consider the form and content of the particular hedge clause (e.g., its accuracy), and any oral or written communications between the investment adviser and the client about the hedge clause. In addition, if the client is unsophisticated, the SEC would consider other factors such as: (i) whether the hedge clause was written in plain English; (ii) whether the hedge clause was individually highlighted and explained during an in-person meeting with the client; (iii) whether enhanced disclosure was provided to explain instances in which the client may still have a right of action; and (iv) the presence, sophistication and extent of assistance provided to a client by an intermediary. Heitman Capital Management, LLC, SEC Staff No-Action Letter (February 12, 2007).

Franklin Mutual Fund Excessive Fee Class Action Dismissed

A Federal District Court judge in New Jersey granted a motion to dismiss a class action brought against various Franklin and Templeton funds and their affiliates alleging that the defendants violated Section 36(b) of the Investment Company Act of 1940 by charging excessive fees. The court based its ruling on two grounds. First, the court held that because certain claims were preempted by the Securities Litigation Uniform Standards Act ("SLUSA"), dismissal of the entire class action was appropriate. Second, the court ruled that even if the claims were not subject to dismissal under SLUSA, the complaint nevertheless failed to state a claim under Section 36(b). The court rejected the plaintiffs' claims against 10 funds because the alleged misconduct occurred before the one-year damages limitation look back period set forth in 36(b). With regard to the plaintiffs' claims against the remaining two funds, the plaintiffs alleged that because these funds were so large, they were analogous to index funds and therefore should have paid fees at the lower rates typically charged for index funds. The court held that this type of general assertion was not sufficient to establish a cause of action that the defendants failed to meet the standard which is applicable to the approval of investment management contracts with mutual fund companies.

Foreign Adviser Not Required to Maintain Insider Trading Reports for Certain U.K. Securities

A U.K.-based investment adviser asked the SEC staff for no-action relief to permit it to amend its code of ethics so as not to require certain of its access persons to report personal securities transactions in certain U.K. government debt securities, U.K. unit trusts and open-ended investment companies; and interests in unit-linked life and pension products sold in the U.K. (the

"U.K. Securities"). The adviser argued that the U.K. Securities are analogous to securities that Rule 204A-1 excludes from the definition of reportable securities (such as U.S. government securities and shares of U.S. open-end mutual funds) and that transactions in the U.K. Securities by the specified access persons did not implicate the concerns that underlie the rule. The SEC staff agreed not to recommend enforcement action to the Commission under Rule 204A-1, against the adviser with respect to transactions in the Securities. However, the SEC staff stressed that the adviser's code of ethics must continue to require execution-related access persons to report their transactions in and holdings of the U.K. securities involving open-end funds. M&G Investment Management Ltd., SEC Staff No-Action Letter (March 1, 2007).

District Court Enjoins Enforcement of Illinois Sudan Act

In 2005, the State of Illinois enacted legislation which prohibited certain investments in the government of Sudan and in companies doing business in or with Sudan This legislation, known as the Illinois Sudan Act (the "Sudan Act"), imposes restrictions on two types of financial entities: 1) depository institutions receiving deposits of state funds, and 2) state and municipal pension funds formed under the Illinois Pension Act. The stated purpose of the Sudan Act is to put pressure on the Sudanese government to help stop atrocities occurring in Sudan. A national trade organization and eight Illinois municipal pension plans brought an action in the U.S. District Court for the Northern District of Illinois seeking to enjoin enforcement of the Sudan Act. The District Court held that the provisions of the Sudan Act applicable to the activities of depository institutions interfered with the federal government's conduct of foreign relations, were preempted by federal law and unconstitutionally interfered with the federal government's power to regulate foreign commerce. The court also concluded that the pension plan provisions were not preempted by federal law and did not interfere with the federal government's conduct of foreign affairs, but violated the Foreign Commerce Clause of the U.S. Constitution. Although the court noted that the Sudan Act's amendments to the Illinois Pension Act might be constitutional if they did not include municipal pension plans, the court could not re-write the statute in this manner.

Bayou Hedge Funds Can Proceed with Bankruptcy Action to Recover Prepetition Redemption Payments to Investors

The United States Bankruptcy Court for the Southern District of New York denied motions to dismiss 95 adversary proceedings brought by Bayou Superfund, LLC, Bayou No Leverage Fund, LLC and Bayou Accredited Fund, LLC to recover payments made to investors who redeemed interests in these funds within the two year "fraudulent conveyance" period preceding the filing of their bankruptcy cases. In reaching this result, the court found that the plaintiffs had sufficiently alleged that the funds were operated as part of a "Ponzi Scheme," and as such the payments to the investors were made with "actual intent to hinder, delay or defraud creditors" for purposes of Bankruptcy Code Section 548(a)(1)(A). The bankruptcy court rejected various arguments advanced by the defendants that the plaintiff was required to allege that the debtor received "less than reasonably equivalent value" for the payments. The judge ruled that this requirement is only applicable to a claim based on constructive fraud under Bankruptcy Code Section 548(a)(1)(B). As a result of these rulings, the defendants will bear the burden of proving the affirmative defense that they acted in good faith in receiving the payments when this case proceeds to a trial. This decision raises the possibility that investors who were fortunate or diligent enough to have redeemed their interests during the two years leading up to the bankruptcy of these funds will have to stand in line with other investors who did not redeem their interests before the commencement of the Chapter 11 proceedings.

Contact Information

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