May 2007

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

Mutual Fund "Shelf Space" Cases Survive Motions to Dismiss

In two recent decisions, federal trial courts have ruled that plaintiffs have stated potentially valid federal securities law claims based on allegations that the defendants failed to disclose the details of their so-called "shelf space" arrangements. One of the cases, Siemers v. Wells Fargo & Co., involves a fund adviser which made "revenue sharing" payments in return for shelf space for its sponsored mutual funds. In Siemers, a putative class action, the United States District Court for the Northern District of California ruled that plaintiffs had alleged sufficient facts to state a claim against Wells Fargo and its affiliates for intentional misrepresentation of material facts under Section 10(b) of the Securities Exchange Act of 1934. Accepting the plaintiffs' allegations as true at this preliminary stage of the proceedings, the court characterized Wells Fargo's alleged payments, totaling $372 million over five years to 472 brokers, as "huge." The court reviewed the language in various versions of the funds' prospectuses and ruled that the complaint sufficiently alleged inadequate disclosures regarding the existence and size of the revenue sharing program, the source of revenue sharing payments, and potential conflicts of interest for the adviser. The court further ruled that the complaint adequately alleged that the defendants and their key officers acted with scienter, by knowing that the revenue sharing program was not fairly disclosed in the prospectuses. The court also expressly stated that the leading case regarding excessive fees under Section 36(b) of the Investment Company Act, Gartenberg v. Merrill Lynch Asset Management, is of "marginal value" when assessing whether a plaintiff has successfully pled a Section 10 claim based on allegations that excessive fees were used for undisclosed purposes.

The case of In re AIG Advisor Group Securities Litigation, another putative class action, involves a broker allegedly receiving shelf space and directed brokerage payments. In that case, brought in the United States District Court for the Southern District of New York, AIG and various of its affiliated broker dealers were alleged to have failed to properly disclose their revenue sharing and directed brokerage activities, in violation of Section 12(a)(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. The complaint alleged (i) misrepresentations on the website of one of the AIG brokers that stated the broker's financial advisors "offer unbiased financial information based solely on your financial agenda and no one else's," and (ii) omissions from the prospectuses and SAIs of the unaffiliated funds that were sold under the shelf space program regarding the potential payment of brokers from fund assets. In this regard, the court rejected the defendants' position that the alleged misrepresentations and omissions concerning the objectivity of the advisers were immaterial as a matter of law, and ruled that knowledge that a broker has a conflict of interest can be material to the broker's customers. The plaintiffs also alleged that the prospectuses and SAIs of all of the various funds in the shelf space program failed to disclose defendants practice of "steering" investors into the shelf space funds. The plaintiffs linked the defendant brokers to the funds' prospectuses and SAIs by alleging that the brokers relied upon them to disclose the existence of the revenue sharing relationships. The brokers denied any such reliance but the court ruled that this was a disputed fact that could not be properly resolved on a motion to dismiss. The defendants also argued that the alleged non-disclosures of the revenue sharing arrangements in the prospectuses were not actionable because SEC Form N-1A only requires disclosure of the total fees paid by the investor in connection with a securities purchase as well as the total commissions paid by the fund. Rejecting this argument, the court ruled that although the defendants were not required to include disclosures regarding the breakdown of these payments in Form N-1A, the defendants could nonetheless be found liable if such disclosures were necessary to make other statements contained in the prospectus not misleading. Based on certain other pleading deficiencies, the court dismissed this action granting the plaintiffs leave to file an amended complaint.

NASD Approves Proposal to Streamline Approval of Sales Material

The NASD Board of Governors has approved a proposal to create an exception to NASD Rule 2210 which requires that all sales materials used by a NASD member firm be approved by a registered principal of such firm prior to its use. Under the proposal, such approval will not be required for sales materials already on file with the NASD. The NASD release states that by eliminating the dual review by registered principals, the proposed rule change will save retail broker-dealers "numerous hours" spent reviewing sales materials previously approved by a registered principal at the securities distributor. This proposal has been submitted by the NASD to the SEC for its approval.

SEC Issues New Guidance Regarding Managed Distribution Plans

The SEC in a letter to the Investment Company Institute, recently indicated that it has approved a revised set of conditions and representations for applications for exemptive orders from Section 19(b) of the Investment Company Act and SEC Rule 19b-1 (the "Amended Conditions"). Section 19(a) generally prohibits registered investment companies from paying any dividends or other distributions from any source other than net income unless the payment is accompanied by a written statement which adequately discloses the source of the payment. With limited exceptions, Section 19(b) generally prohibits investment companies from distributing long-term capital gains more often than once every fiscal year. Detailed requirements with regard to the form, content and delivery of the written notice required by Section 19(a) are set forth in Rule 19a-1, which is intended to ensure that investors are clearly notified that the sources of the distributions they are receiving include sources other than net income. The SEC has previously granted exemptive orders to permit closed-end funds to make more frequent distributions of long-term capital gains than Section 19(b) and Rule 19b-1 would otherwise allow, subject to certain conditions. However, for approximately the last three years the SEC has not acted on any requests for such exemptive orders. The SEC staff has indicated that it is now willing to process requests for 19(b) exemptive orders in accordance with the revised conditions.

The Amended Conditions require that the fund adopt a plan (the "Plan") to make periodic level distributions. In approving the adoption of the Plan, the fund board, including a majority of its independent directors, must determine that the Plan is in the best interest of the fund and its shareholders after considering, among other things, any potential or actual conflict of interest that the adviser may have relating to the Plan and whether the rate of distribution of the Plan will exceed the fund's expected total return. The applicant must also represent that the fund has approved compliance policies and procedures pursuant to Rule 38a-1 that are reasonably designed to ensure that all notices required to be sent to fund shareholders pursuant to Section 19(a), Rule 19a-1 and the Amended Conditions will comply with such requirements, and require the fund to keep records that demonstrate the calculation of the amounts contained in such notices. The fund's Chief Compliance Officer must review the adequacy of these procedures, and the fund's compliance therewith. The Chief Compliance Officer must also report back to the board no less frequently than once every three months or at the next regularly scheduled board meeting. The Amended Conditions also significantly increase the amount of disclosure required in the notice to shareholders, including requiring the inclusion of several measures of fund performance. The Amended Conditions require that the information in the notice to shareholders also be included in the fund's website and in a press release issued contemporaneously with the notice to shareholders. Additionally, the information in the press release must be filed with the SEC as an exhibit to the fund's next filing on Form N-CSR. The Amended Conditions impose detailed disclosure requirements with respect to fund reports to shareholders and in communications relating to the Plan to shareholders, prospective shareholders and third-party information providers. The Amended Conditions also require that if the fund's shares are owned in street name by a broker, bank or other financial intermediary, the fund must request that intermediary forward the 19(a) notices to the beneficial owners and, upon request, the fund must pay the financial intermediary for the costs it incurs in sending out such 19(a) notices.

Supreme Court to Review Municipal Bond Case

The United States Supreme Court has agreed to hear an appeal of a Kentucky state-court decision that might significantly affect how states tax in-state and out-of-state municipal bonds. Like most states, Kentucky exempts from state taxation the income earned on municipal bonds that it or its political subdivisions issue but does not similarly exempt income earned on municipal bonds issued by any other state or political subdivision. The Kentucky Court of Appeals declared this arrangement unconstitutional on the grounds that it discriminates against interstate commerce by impermissibly favoring in-state bonds over out-of-state bonds. A reversal by the Supreme Court on substantive grounds should provide comfort to other states that treat municipal bonds under an approach similar to Kentucky's. If the Supreme Court affirms the Kentucky decision, other states will likely have to revisit the way in which they treat the interest on municipal bonds, and this has the potential to affect directly the attractiveness of municipal bonds to investors. The Supreme Court likely will hold oral arguments on this case in the fall and issue a decision sometime thereafter. We will provide additional information on, and analysis of, this issue in future Investment Management Updates.

NYSE Files Proposal to Permit Broker Voting on Election of Mutual Fund Directors

As we reported in the November 2006 issue of the Investment Management Update, the New York Stock Exchange ("NYSE") filed a proposal with the SEC to change NYSE Rule 452 to prevent brokers from voting on the non-contested election of directors as a "routine" matter. This proposal caused concern in the mutual fund industry because it would have made it more difficult for funds to obtain a sufficient shareholder presence to convene meetings. The Investment Company Institute ("ICI") estimated that the original NYSE proposal could cause funds' proxy voting costs to double because of the need for additional solicitation efforts, thereby increasing fund expenses with little, if any, demonstrable benefit to shareholders. According to published reports, after reviewing data provided by the ICI, the NYSE concluded that mutual funds are different from operating companies for these purposes, and has submitted a revised proposal to the SEC that would allow brokers to continue to vote fund shares in non-contested election of directors as a routine matter.

Contact Information

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

© 2007 Ropes & Gray LLP