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

SEC Chairman Cox Asks Congress to Repeal Soft Dollars

SEC Chairman Cox recently sent letters to Senate and House leaders urging them to consider legislation that would repeal or substantially revise Section 28(e) of the Securities Exchange Act of 1934, which provides a safe harbor for the use of soft dollars by investment advisers. According to Chairman Cox's letters, soft dollar arrangements are "troubling" for several reasons. First, the letters assert that such arrangements encourage money managers to "overtrade" client portfolios in order to generate soft dollar credits to obtain research. The letters state that at times managers may use this research primarily, and sometimes solely, for the benefit of a group of clients that is different from the clients whose trades are used to generate the soft dollar credits. Second, the letters express Chairman Cox's view that soft dollar arrangements may contribute to higher brokerage costs and that clients find it impossible to understand the reasons why their money manager has decided to execute various trades through a particular soft dollar broker-dealer. The letters go on to state that the market conditions which may have justified the adoption of Section 28(e) in 1975 no longer exist, and money managers are now able to adapt their practices by paying separately for the research provided by brokers. At the conclusion of his letters, Chairman Cox offered to submit legislative language to address these issues.

Legislation Filed to Eliminate Capital Gains Treatment of 'Carried Interests'

House Democrats filed proposed legislation on June 22 that would change certain federal tax laws so that "the managers of investment partnerships who receive a carried interest as compensation will pay regular income tax rates rather than capital gains rates." The proposed legislation, which was introduced by Rep. Sander Levin, comes on the heels of Senate and House proposals to tax as corporations publicly traded investment firms treated as partnerships for tax purposes, but if enacted the Levin bill would have a much more sweeping effect. The Levin bill would cause profits interests in private equity funds, hedge funds, venture capital funds, real estate funds, commodities funds and other investment partnerships to be taxed at ordinary income rates. Depending on the circumstances, the bill could also apply to profits interests in holding company partnerships and partnerships engaged in operating businesses. For further details regarding this legislative development, please see Ropes & Gray's recent Client Alert on this topic.

Barclays Settles SEC Insider Trading Enforcement Action

On May 30, 2007, the SEC filed and settled a civil action against Barclays Bank PLC and a former proprietary trader for Barclays' U.S. Distressed Debt Desk. According to the SEC's complaint, Barclays traded millions of dollars of bond securities over an 18-month period, during which the trader was in possession of material non-public information about certain bonds. The trader allegedly obtained this information as a result of having served as Barclays' representative on six creditors' committees. The complaint alleges that the defendants violated Section 10(b) of Securities Exchange Act of 1934 and Rule 10b-5 by misappropriating material non-public information from creditors' committees, issuers and other sources and then trading while in possession thereof. The SEC noted that in a few instances the trader used so-called "big boy" letters in which Barclays' trading counterparties acknowledged that they agreed to enter into the securities transactions with Barclays, notwithstanding the fact that Barclays may have been in possession of material non-public information. The SEC, however, did not consider the big boy letters to be a valid defense to its allegation. Industry participants have long been aware that the SEC has never recognized big boy letters as a valid defense to Rule 10b-5 liability. The Barclays settlement confirms that

under certain circumstances the SEC will not be reluctant to bring a Rule 10b-5 enforcement action even where all of the parties are sophisticated institutional investors and a big boy letter has been used. As a result, the use of big boy letters by market participants needs to be carefully analyzed on a case-by-case basis. Factors to consider when using big boy letters include how strong a case can be made that the information is material and/or non-public; what is the source of the information; the level of knowledge and sophistication of the counterparty; and whether there is a public resale market for the securities in question.

Massachusetts Secretary of State Files Enforcement Action Against Hedge Fund Prime Broker

The Enforcement Section of the Securities Division of the Massachusetts Secretary of State's office has filed an Administrative Complaint against a broker-dealer alleging that the broker-dealer violated the Massachusetts Securities Act and state regulations by providing hedge fund advisers with free or reduced rent, free use of information technology personnel and other office personnel, low interest rate personal loans and tickets to sporting events and other forms of entertainment in violation of NASD Rule 3060. According to the complaint, the broker-dealer gave the rent breaks and other benefits to hedge fund advisers as a quid pro quo to induce such advisers to use the broker-dealer's prime brokerage services for their hedge funds. In order to continue to receive these benefits, the advisers were allegedly required to cause their hedge funds to generate certain minimum levels of revenues through the use of prime brokerage services provided by the broker-dealer. The Secretary of State alleges that these economic benefits, which inured to the benefit of the advisers rather than the investors in the hedge funds, created impermissible conflicts of interest between the advisers' own economic interests and their fiduciary duty to obtain best execution for their clients. The complaint cites the broker-dealer's lack of clear disclosures about these conflicts to clients, the failure to implement appropriate policies and procedures regarding these conflicts, and inadequate record keeping concerning the business entertainment expenses as grounds for the relief requested in the complaint.

NASD and NYSE Propose New Guidance Regarding Electronic Communications

The National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") have requested comment on their proposed joint guidance regarding the review and supervision of electronic communications (the "Joint Guidance"). The Joint Guidance begins by noting that members are required to adopt policies and procedures for a supervisor's review of employees' incoming and outgoing electronic communications under SRO rules and federal securities laws. Examples of these rules include rules regarding communications between research and non-research departments, identification and reporting of customer complaints and prior approval of trades. The Joint Guidance also recognizes that the policies and procedures need to be frequently updated and that policies written five years ago may not address technologies such as weblogs, podcasting and E-Faxes. Members are also advised in the Joint Guidance of the need to give their employees a clear list of permissible and prohibited types of electronic communications. The Joint Guidance indicates that members may consider the following methods for review of electronic correspondence: lexicon-based methods (based on a search for sensitive words or phrases, the presence of which may signal problematic communications); random sampling methods (based on a review of some percentage of the total communications); or a combination of lexicon-based and random sampling methods. Members must maintain appropriate records of such reviews, which should, the Joint Guidance emphasizes, at a minimum, clearly identify the reviewer, the communication that was reviewed and the steps taken as a result of any significant regulatory issues that were identified during the course of the review. Comments on the Joint Guidance are due by July 13, 2007.

NASD and NYSE Request Comment on Proposed Business Entertainment Rules

The SEC has published a notice to solicit comments on changes to the Interpretive Material for NASD Rule 3060 to require its members to adopt policies and procedures addressing business entertainment. The SEC also published a notice regarding a similar proposal made by the NYSE to adopt a new Rule 350A regarding business entertainment. The two proposals are substantially similar except that the NYSE proposal contains an additional "Notice to Customers" provision discussed below. NASD Rule 3060 prohibits any member from making gifts having a value of more than $100 per year to any person. In 1999, NASD staff issued an Interpretative Letter stating that Rule 3060 does not prohibit "ordinary and usual business entertainment." The proposed guidance, which comes in the wake of recent press reports of enforcement actions regarding lavish entertainment offered by brokers to certain mutual fund traders and portfolio managers, is intended to provide more detailed guidance on what types of business entertainment are permissible. The new guidance applies to business entertainment provided to a "customer representative," which is defined as a person who is an employee, officer, director or agent of a customer of the member (excluding a person who is a family member of the customer). The standard adopted in the proposals is to prohibit any business entertainment that would reasonably be judged to cause the customer representative to act in a manner that is inconsistent with the best interests of either (i) the customer or (ii) any person to whom the customer owes a fiduciary duty. The proposal also provides that if the customer is not accompanied by an appropriate associated person of the member to the event, function or other entertainment, then the expenses must be treated as a gift under Rule 3060, unless exigent circumstances arise which prevent the associated person from attending. Under the proposed rules, the member is required to adopt written policies and procedures concerning business entertainment that must impose either specific dollar limits on how much can be spent on business entertainment or require advance written supervisory approval for expenses beyond specified dollar limits. The proposed text of NYSE Rule 350A includes an additional requirement that each member must have a system in place to give notice to customers who utilize customer representatives that upon the customer's written request, the member will promptly provide detailed information regarding the "manner and expense" of any business entertainment provided to their customer representative(s).

Contact Information

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