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

SEC Amends Advisers Act Rules

On July 11, 2007, the SEC adopted a new anti-fraud rule, Rule 206(4)-8 (the "Anti-fraud Rule"), applicable to advisers of virtually all types of pooled investment vehicles, including hedge funds, private equity and venture capital funds, and registered investment companies ("Pooled Vehicles"). The Anti-fraud Rule's adoption comes in response to a decision of the United States Court of Appeals for the D.C. Circuit in Goldstein v. SEC. In Goldstein, the court invalidated the SEC's rule, which had changed the manner of counting an adviser's clients for purposes of the fifteen or fewer client exemption from the Investment Advisers Act federal registration requirements. Although the SEC decided not to appeal the Goldstein decision, the agency remained concerned about the implications that certain statements in the Goldstein decision might have on its anti-fraud jurisdiction. Generally, the Anti-fraud Rule aims at prohibiting fraud by Pooled Vehicle advisers against investors and prospective investors in Pooled Vehicles. It applies to advisers that are exempt from registration with the SEC or the states, and it may apply to foreign entities as well. The Anti-fraud Rule creates a new two-pronged definition of what constitutes a "fraudulent, deceptive, or manipulative act, practice, or course of business" within the meaning of Section 206(4) of the Advisers Act. The first prong of the Anti-fraud Rule encompasses material misstatements and omissions to investors or prospective investors. The second prong applies to any investment adviser that "[o]therwise engage[s] in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor" in the Pooled Vehicle. Unlike many other existing securities laws, scienter is not required under the Anti-fraud Rule, and therefore liability is imposed for negligent (as opposed to intentionally) misleading statements. In addition, the rule imposes liability for deceptive conduct that does not involve misstatements or omissions. The Anti-fraud Rule also states that it does not create a private right of action and disclaims any attempt to create new fiduciary duties. The new rule becomes effective on September 10, 2007.

SEC Proposes Changes for Private Placement Filings

The SEC published proposed rules which would change the content and method of filing of Form D under the Securities Act of 1933. Form D is a notice of an offering of securities made without registration under the Securities Act in reliance on an exemption provided under Regulation D. The proposed rules are intended to reduce the cost and burden of preparing and filing Form D and to enhance the value of the data collected. Changes to existing practice contained in the proposed rules include: (i) mandatory filing of Form D through an Internet-based electronic filing system; (ii) greater specificity and uniformity about the information required to be disclosed about the issuer, such as its industry group, its anticipated revenue range, and the specific exemption and/or exclusion from registration being claimed for the offering; (iii) elimination of the requirement that the issuer identify owners of 10 percent or more of a class of their equity securities as a "related person;" (iv) clarification of when an amendment to the Form D must be filed; and (v) an undertaking to furnish state and federal regulators the information provided by the issuer to offerees. Comments on the proposed rule are due by September 7, 2007.

NASD Requests Comment on Proposal to Regulate Member Private Securities Offerings

In response to problems identified as a result of sweep exams and enforcement cases, the NASD has issued proposed Rule 2721 with respect to private placements of securities issued by a NASD member or a "controlled" affiliate. The NASD's review of member private placements revealed a number of causes for what it described as "widespread problems" in this area, including misleading, incorrect or selective disclosure in private placement memoranda ("PPMs"), particularly with respect to selling compensation and the use of offering proceeds. The proposed rule would require that:

- a PPM be provided to each investor with information regarding risk factors, intended use of proceeds, offering expenses and any other information necessary to ensure that required information is not misleading;
- the PPM be filed with NASD's Corporate Financing Department at or prior to the time it is provided to any investor; and
- at least 85 percent of the offering proceeds be used for the business purposes identified under the "use of proceeds" disclosure in the PPM.

The proposed rule includes various exemptions, including member private placements which are sold solely to institutional accounts (as defined in NASD Rule 3110(c)(4)); qualified purchasers (as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940); qualified institutional buyers (as defined in SEC Rule 144A of the Securities Act); investment companies (as defined in SEC Rule 144A); an entity composed exclusively of qualified institutional buyers (as defined in SEC Rule 144A); and banks (as defined in SEC Rule 144A). As noted in the release, SEC regulations do not require that any disclosure documents be prepared and provided to investors in connection with offerings made solely to accredited investors. Therefore, the NASD Rule goes beyond the disclosure requirements currently imposed under federal securities laws. The comment period on the proposed rule expires July 20, 2007.

Department of Labor Publishes Final Rules Regarding Form LM-30

Form LM-30 implements the requirements of Section 202 of the Labor-Management Reporting and Disclosure Act of 1959, which requires officers and employers of Labor Unions to report certain transactions involving possible conflicts between their personal financial interests and their duties to the labor union and its members. Of particular concern to the financial services industry are the provisions which require union officials to report payments and other financial benefits received from service providers to Section 3(l) Trusts, which include trusts set up by unions to provide benefits to their members, such as pension or welfare plans. The Department of Labor received numerous objections to these provisions by various groups within the financial services industry, which viewed this requirement as an "expansion" of the Form LM-30 reporting obligations. In its adopting release the DOL devoted significant attention to explaining why it did not agree with this characterization and refuting other objections contained in the comments it received from the financial services industry.

New Delivery Methods for Proxy Materials

The SEC has adopted amendments to its proxy rules that permit shareholders to choose the means by which they can obtain proxy materials. Under the new rule, issuers and other persons soliciting proxies must post their proxy materials on an Internet Web site and provide shareholders with notice on how they can access these materials electronically. The notice of Internet availability must be given at least 40 days before the shareholders meeting. The issuer is also given the option of providing paper copies of the materials together with the notice. The rule provides that Registered Investment Companies must comply by January 1, 2009.

Treasury Regulations Proposed on Diversification Requirements for Variable Contracts

On July 30, 2007, the Treasury Department issued proposed regulations concerning the diversification requirements under Section 817(h) of the Internal Revenue Code (the "Code"). Section 817(h) provides that a variable contract based on a segregated asset account shall not be treated as an annuity, endowment or life insurance contract (and thus shall not be eligible for tax deferrals on investment returns generated by the segregated assets funding the contract during the contract's period of accumulation) unless the segregated asset account is adequately diversified in accordance with Treasury regulations.

Section 817(h)(4) and Treas. Reg. § 1.817-5(f) provide rules for when a segregated asset account is permitted to "look through" its investments in an investment company that qualifies as a regulated investment company under Subchapter M of the Code, a real estate investment trust, a partnership or a so-called "grantor trust" for purposes of determining whether it has met the Section 817(h) diversification test, provided that the beneficial interests therein are owned only by segregated asset accounts and certain other permitted investors, including the trustees of qualified pension or retirement plans (already eligible for tax deferral under separate Code provisions). The proposed regulations would expand the list of such permitted investors to include (1) qualified tuition programs as defined in Code Section 529 ("529 plans");[1] (2) trustees of foreign pension plans established and maintained outside the U.S., primarily for the benefit of individuals, substantially all of whom are nonresident aliens; and (3) accounts that, pursuant to Puerto Rican law or regulation, are segregated from the general asset accounts of the life insurance companies that own the accounts, provided certain Section 817 requirements are met.[2] The proposed regulations would also give the Treasury Department additional latitude in settling cases involving inadvertent failures to diversify segregated asset accounts.

The proposed regulations will not take effect until the Treasury Department issues the regulations in final form.

Contact Information

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

[1] The inclusion of 529 plans as permitted investors for purposes of the Section 817(h) diversification test would not relieve those plans of the need to satisfy all requirements of Section 529 and the regulations thereunder. In particular, the preamble notes that the inclusion of such plans does not imply that an investment in a single investment company or other pooled investment vehicle discussed above satisfying the minimum diversification requirements under Section 817(h) would necessarily be treated as a permitted investment under Section 529, whether as a "broad-based investment strategy" within the meaning of IRS Notice 2001-55 or otherwise.

[2] The Treasury Department and the IRS requested comments on whether rules similar to those proposed to apply to accounts that are segregated pursuant to Puerto Rican law or regulation should apply to accounts that are segregated pursuant to the laws or regulations of other territories. Therefore, any final regulations could expand the list of permitted investors to include segregated asset accounts of other U.S. territories.