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

Derivative Action Dismissed Based on Fund Board's Determination Not to Pursue Claims

A derivative action brought on behalf of the shareholders of the Merrill Lynch Focus Twenty Fund, Inc. (the "Fund"), against the Fund's adviser and its officers was dismissed by the United States District Court for the Eastern District of New York after the Fund's board of directors determined that it was not in the best interests of the Fund to pursue the plaintiffs' claims. The complaint alleged that the defendants breached their fiduciary duties in causing the Fund to invest in the stock of Enron Corporation, which subsequently became worthless. A previous complaint asserting the same claims was dismissed by the court on October 30, 2003, on the grounds that under Maryland law, which applied because the Fund was organized as a Maryland corporation, a derivative action could not be maintained where the plaintiffs failed to make demand on the Fund's board before initiating the lawsuit.

After the first case was dismissed, the plaintiffs sent a letter to the Fund's board of directors requesting that they take action to recover the Fund's losses incurred with respect to the Enron stock. In response, the board appointed an Independent Investigative Committee (the "Special Committee") which retained outside counsel to assist in the investigation of the plaintiffs' claims. The Special Committee proceeded to conduct an investigation, which took place over a period of nine months. The investigation included the review of over 375,000 pages of documents; interviews with numerous persons believed to possess relevant information about the matters under investigation; and formal committee meetings on 10 separate occasions. After these investigations, the Special Committee generated a 73-page report that set forth the Special Committee's procedures, identified the claims at issue, and explained the Special Committee's reasoning and findings.

Although both parties agreed that the board's decision fell within the protection of the "business judgment rule," they disagreed over the appropriate standard of review to be applied to such decisions. The defendants argued that Maryland courts would apply the standard set forth by the New York Court of Appeals in Auerach v. Bennett, which limits the court's inquiry to only two issues – whether the scope of the investigation was appropriate and whether the committee members were sufficiently independent. The plaintiffs argued that the appropriate standard for judicial review under Maryland law is the standard set forth by the Delaware Supreme Court in Zapata Corp. v. Maldonado. Zapata provides for a two-prong review process in which the court takes the additional step of determining whether the board's investigation satisfies the business judgment of the court. Although the District Court noted that it did not think that Maryland law requires the additional second step of review that is required under Zapata, it concluded that it did not need to resolve this legal question. Based on its review of the process followed by the Special Committee and the facts of the case, the District Court concluded that the recommendation made by the Special Committee had a reasonable basis and that the conclusion of the Special Committee was consistent with the District Court's own business judgment.

GAO Issues Report to Congress Regarding SEC Investment Adviser/Investment Company Examination Program

In late 2003, following the publicity concerning mutual fund late trading and market timing scandals, the SEC's Office of Inspections and Examinations ("OCIE") decided to discontinue its program of attempting to routinely examine all advisers every three years, regardless of risk, in favor of a risk-based approach. The GAO report summarizes the review conducted by the agency as to OCIE's implementation of its risk-based examination program and also discusses OCIE's compliance with

its examination exit procedures and certain reforms OCIE implemented since January 2006 to improve its communications with registered firms.

The GAO Report states that in fiscal year 2005, OCIE implemented a program to examine "higher risk" firms, which comprise approximately 10% of all registered firms, once every three years. The OCIE's program also calls for the examination of a small random sample of the remaining 90% of the firms that are designated as "lower risk." The GAO noted that the effectiveness of OCIE's risk-based approach depends on its ability to accurately rate the level of risk at individual investment advisers. Although OCIE began assigning risk ratings to advisers in 2002, based on its routine examination program, most firms have not yet received this evaluation. For these firms, OCIE assigns risk ratings based on information obtained through publicly available sources, such as disclosures regarding conflicts of interest. The GAO Report notes that these indicators have various "limitations," including the fact that they do not provide any information with regard to the effectiveness of the firm's policies and procedures for mitigating these risks. The GAO therefore renewed its prior recommendation that OCIE obtain information from the firm's own compliance reviews that are required under SEC rules, and that OCIE utilize this information to make a better assessment of a firm's risk assessment rating.

FINRA Focuses on Protection of Senior Investors

The Financial Industry Regulatory Authority ("FINRA"), the renamed organization formed by the combination of the regulatory organizations of the NASD and the NYSE, has taken a series of actions to highlight its regulatory focus on the protection of senior investors. FINRA recently announced that it has initiated two major regulatory sweeps: one directed at the use by brokers of so-called "professional" designations to mislead or defraud investors (such as "Certified Senior Adviser"), and another concerning certain early retirement seminars conducted by securities firms to entice older workers to liquidate their retirement funds and invest them with a specific firm or representative. FINRA currently has two other regulatory sweeps ongoing in this area: one examining the sale of collateralized mortgage obligations targeted at seniors, and a second investigating sales practices with regard to life settlements.

FINRA also issued Regulatory Notice 07-43 (the "FINRA Notice") urging all of its members to review and, where appropriate, enhance their policies and procedures in light of senior investor protection concerns. In the FINRA Notice, members are reminded of their obligations under various existing rules, such as suitability, the use of credentials and professional designations. The FINRA Notice also discusses at some length the problem of diminished capacity and suspected financial abuse of seniors. The FINRA Notice discusses a number of steps firms are taking to address these issues, although no suggestion is made that these steps are required under FINRA regulations.

SEC Proposes Changes to Private Placement Rules

The SEC has proposed extensive changes to its rules applicable to private offerings. These proposals will, if adopted, create a new exemption from Securities Act registration for a new category of investors called "large accredited investors;" provide an alternative "investments-owned" standard to the current "net worth" test that must be met for an investor to qualify as an accredited investor; revise the rules relating to the integration of a private sale and a subsequent or concurrent public offering; and provide uniform standards for the disqualification of certain persons from the ability to make a private offering under Reg. D. The proposed definition of large accredited investors includes legal entities having in excess of $10 million in investments and natural persons having in excess of $5 million in investments. Issuers of securities sold exclusively to large accredited investors will be permitted to do limited types of advertising. However, this rule is not available to pooled investment vehicles relying on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940. Under the SEC's proposal, a person can be deemed to be accredited if the value of his or her net worth exceeds

$1 million or if the value of their investments exceeds $750,000. Both of these thresholds will be adjusted for inflation every five years. Unlike the net worth test, the term "investments" does not include the investor's personal residence. In December 2006, the SEC proposed to add a new category of investor, called an "accredited natural person," as part of its efforts to enhance investor protection in the area of hedge fund investments. The SEC is also soliciting further comments on the previously proposed "accredited natural person" definition, especially with regard to the impact of the newly proposed changes to Reg. D.

Contact Information

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