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

Recent Rulings May Help Ease Liquidity Crisis for Closed-End Preferred Shareholders

The Securities and Exchange Commission (SEC) Staff and the Treasury Department recently issued decisions aimed at providing sources of liquidity to alleviate the current disruption of the market for auction rate preferred shares (ARPS). The SEC Staff granted no-action relief which would allow open-end investment companies that hold themselves out as money market funds to purchase a new security called Liquidity Protected Preferred Shares (LPP) that would replace or supplement a closed-end fund's ARPS. The LPP will pay a dividend that will be reset every seven days in a remarketing or action process similar to the process formerly used to set the rates for ARPS, except that each fund will enter into an agreement with a third party liquidity provider obligating the liquidity provider to purchase unconditionally all LPPs that are not purchased by other investors.

The applicant also requested and was granted no-action relief to the effect that LPP did not constitute a "redeemable security" and thereby did not result in the issuer being deemed to be an open-end investment company. The SEC Staff also agreed that it would not view the purchase of LPP as constituting a tender offer under Sections 13(e), 14(a) and 14(e) of the Securities Exchange Act of 1934. In issuing the no-action letter, the SEC Staff considered a number of other facts described by the applicant, including the issuer's intent that the funds and the LPP will be sold only to Qualified Institutional Buyers in a private placement. Eaton Vance Management, SEC No-Action Letter, dated June 13, 2008.

Also, the Treasury Department issued Notice 2008-55 (Notice) which provides that the Internal Revenue Service will not challenge the equity characterization of certain ARPS issued by closed-end funds as a result of the funds' adding a liquidity facility to support their ARPS if the conditions of the Notice are met. The Treasury originally issued the Notice on June 13, 2008, but subsequently released a revised version of the Notice which made revisions to four of the conditions imposed by the original Notice. As a result of the Notice, tax-exempt funds opting to support their ARPS with a liquidity facility pursuant to the conditions of the Notice can continue to pass through "exempt-interest dividends" to their ARPS holders.

The guidance provides limited administrative relief, applying only to closed-end management companies that are "regulated investment companies" (as defined in the Internal Revenue Code) that invest predominantly in debt instruments and whose other investments are incidental to the business of investing in the debt instruments. This applies only with respect to ARPS that were outstanding on February 12, 2008 (the date on which significant auction failures first occurred) or issued after that date to refinance ARPS outstanding on that date. In addition, the Notice permits a fund's liquidity facility arrangement to provide the liquidity provider with the contractual right to require the fund to redeem ARPS purchased by the liquidity provider so long as, among other things, the right cannot be exercised until the ARPS have been held by the liquidity provider for a minimum continuous period of six months.

SEC Proposes Stricter Regulations for Credit Ratings Agencies; New Rules for Money Market Funds

In the wake of recent turmoil in the credit markets, the role of certain Nationally Recognized Statistical Rating Organizations (NRSROs) that rated subprime Residential Mortgage-Backed Securities (RMBS) and Collateralized Debt Obligations (CDOs) has been a topic of significant discussion and scrutiny. Responding to concerns expressed by various market participants, the SEC approved parts 1 and 2 of proposed amendments to its rules governing NRSROs on June 11, 2008. The first part of the SEC's proposed regulations attempts to address the conflicts of interest that arose when NRSROs were repeatedly issuing ratings for structured finance products sponsored by the same "arrangers." For example, the proposed new regulations would require additional disclosures about the extent of the economic relationship between the arrangers and the NRSRO. The new regulations also provide that the information used by the NRSRO in determining the credit rating be disclosed through a means designed to provide "reasonably broad dissemination of the information." The SEC believes that by requiring this information to be made public, it could then be used by other market participants to formulate "unsolicited ratings" that could be compared with the ratings issued by the NRSRO hired to rate the product.

An NRSRO would also be prohibited from issuing a credit rating where a person affiliated with the NRSRO makes recommendations about how to obtain a desired credit rating during the rating process. Persons involved in making the rating determinations on behalf of an NRSRO are also prohibited from being involved in discussions about the fees to be paid to the NRSRO by arrangers of the product. The proposed regulations would also limit the value of any gifts received by NRSRO personnel from the arrangers of a security to not more than $25. Comments on parts 1 and 2 of the proposed rule must be submitted on or before July 25, 2008.

The second part of the proposed rules contain new requirements aimed at alerting investors to the differences between the rating methodologies and risk characteristics associated with structured finance products and those used by NRSROs for more traditional types of securities. Under the proposed new regime, an NRSRO would have the option of either publishing a detailed report about its methodologies and assumptions for rating structured products, or would be allowed to use ratings symbols for structured finance products that are different than the ratings symbols used for other types of securities.

The third part of the proposed regulations was approved by the SEC on June 25th and is designed to reduce reliance by investors on credit ratings issued by NRSROs. According to the Director of the SEC's Investment Management Division, the proposed rule changes will include a number of changes to Rule 2a-7 under the Investment Company Act, which governs investments made by money market funds. The text of the rule proposal is not yet available and will merit careful analysis when it is, but considerable detail already has been disclosed.

Currently Rule 2a-7 limits money market fund investments to securities which are rated in one of the two highest short term ratings categories. The new regulations, if adopted, would eliminate references to credit ratings in four principal ways. First, by amending Rule 2a-7 to require that money market funds make the determination that each portfolio instrument presents minimal credit risks, and regardless of whether the credit rating of the security qualifies it as a "First Tier Security" or a "Second Tier Security" for purposes of the rule. Second, the proposed amendments would impose an additional requirement that the securities in which it invests are sufficiently liquid to meet reasonably foreseeable redemptions. Third, the proposed amendments would revise Rule 2a-7's downgrade and default provisions. Instead of relying on a downgrade in the credit rating to trigger a review by the fund board, the proposed amendments would require such review any time the money market fund's investment adviser becomes aware of any information about a portfolio security or an issuer of a portfolio security that suggests that the security may not continue to present minimal credit risks. Finally, the proposed amendments would require that money market funds provide the Commission with prompt notice when an affiliate of the money market fund (or its promoter or principal underwriter) purchases from the fund a security that is no longer an Eligible Security, pursuant to Rule 17a-9 under the Investment Company Act.

Investment Company Act Rule 2a-46 Modified to Expand the Definition of "Eligible Portfolio Company"

The SEC recently amended Rule 2a-46 under the Investment Company Act of 1940 (the 1940 Act), expanding the definition of "eligible portfolio company" to allow for a broader range of permissible investments by business development companies (BDCs). Generally speaking, BDCs are not permitted to acquire any assets other than assets of the type listed in Section 55(a) of the 1940 Act (so-called qualifying assets) unless at the time of such acquisition, qualifying assets represent at least 70 percent of their total assets. Before this amendment, securities of companies listed on a national securities exchange often would not be "eligible portfolio companies" and therefore often did not constitute qualifying assets. The amendment expands the definition of eligible portfolio company to include companies that are listed on an exchange and have less than $250 million in market capitalization.

The amendment will become effective on July 21, 2008.

SEC No-Action Letter Addresses Accounting Treatment of Investments by Registered Investment Companies in Commodities through Wholly-Owned Subsidiaries

The SEC Staff issued a No-Action letter dated April 29, 2008, stating that it would not recommend enforcement action if a registered investment company that principally invests in securities of companies engaged in gold-related activities consolidates its financial statements with those of its wholly-owned Cayman Islands subsidiary. Under Subchapter M of the U.S. Internal Revenue Code (Code), a company will not qualify as a "regulated investment company" unless at least 90% of its gross income is considered to be "qualifying income." Normally, a registered investment company cannot invest a substantial portion of its assets in commodities such as gold, because the income derived from investments in commodities is not considered to be qualifying income. In order to gain exposure to commodities investments, the sponsor of the fund formed a Cayman Islands subsidiary pursuant to an IRS ruling which concluded that income arising from certain foreign corporations that invest in commodities and commodities-linked investments constitutes qualifying income. The fund agreed to limit its investment in the subsidiary to 25% of its assets at the end of each quarter in order to comply with the investment company diversification test under Section 851(b)(3)(B) of the Code.

The applicant argued for a favorable response from the SEC based on the benefits that would accrue to shareholders if the subsidiary's financial statements were consolidated with those of the registered investment company, namely, that shareholders would benefit from a more transparent presentation of the fund's financial position and strategy, owing to the fact that the subsidiary's sole purpose is to allow the fund to gain direct exposure to certain commodities. The SEC agreed that a registered investment company should be able to consolidate its financial statements with a subsidiary that would be a registered investment company itself but for certain statutory exemptions, so long as the result is greater transparency and accuracy of financial statements for investors. Fidelity Select Portfolio, SEC No-Action Letter, dated April 29, 2008.

Proposed Rules Require Mutual Funds to Provide Interactive Risk/Return Information

The SEC recently proposed a rule that would require open-end mutual funds to provide risk/return summary information in an interactive data format, eXtensible Business Reporting Language (XBRL), as an exhibit to their registration statements filed on Form N-1A. Under the proposed rule, each open-end mutual fund would be required to provide the interactive data on its website and to the SEC. This proposed rule builds on a program, started in 2007, that encouraged mutual funds voluntarily to submit supplemental information to their risk/return summaries in interactive data format. It also follows another rule proposed by the SEC a few weeks earlier that similarly would require operating companies (i.e., companies other than investment companies registered under the Investment Company Act) to submit their financial information to the SEC in XBRL. The SEC believes that by requiring risk/return summaries to be made available in XBRL, investors will be able to download information and analyze it using commercial, off-the-shelf software, facilitating the comparison of costs, performance and other information across mutual funds.

The proposed rule does not change current disclosure requirements and would apply to filings effective after December 31, 2009. The interactive data submissions would be filed as post-effective amendments under Rule 485(b) of the Securities Act of 1933 and would be required to be posted after filings become effective, but no later than 15 business days after the effective date. If a mutual fund fails to submit interactive data, the fund's ability to file post-effective amendments would be suspended. Comments on the proposed rule must be submitted on or before August 1, 2008.

Contact Information

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