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

Investment Management Division Discusses Current Priorities

At a meeting of the Mutual Fund Directors Forum held on September 25th in Washington, D.C., Andrew "Buddy" Donahue, the Director of the Securities and Exchange Commission's ("SEC") Division of Investment Management, and members of his staff expressed their views as to various regulatory initiatives currently under consideration. Based on the discussion at the meeting, the SEC Staff expects the following three proposed rules will be finalized and go to the Commission in the 4th Quarter of 2008: Summary Prospectus, XBRL Requirements and ETFs. The Staff is working on a release providing guidance on valuation issues, which is intended to summarize previous rulings, but that release will not come out this year. The Staff indicated that revisions to Rule 12b-1 and Rule 2a-7 will also require additional consideration before they are ready to be proposed.

With regard to the guidance concerning mutual fund directors' oversight of advisers' trading practices, Thomas Smith of the SEC Staff said that the intent of the guidance was not to establish a checklist of items that a board had to follow in every case. Rather, the intent was to provide a list of topics the Staff thought might be relevant and that the board could choose from (or add to) in designing its own oversight protocol. Mr. Donahue added that the Division of Investment Management did not expect directors to go through the details of every best execution report provided by an adviser, but the Staff expects directors to understand how the adviser does its evaluation of best execution and to obtain comfort that the adviser has adequate tools and resources allocated to properly address these issues.

Massachusetts Adopts Strict Data Security Regulations

The Massachusetts Office of Consumer Affairs and Business Regulation has issued new regulations which impose significant requirements on companies that have personal information about Massachusetts residents. Effective January 1, 2009, the regulations require companies to develop a comprehensive security program to safeguard any electronic or paper record that contains such information. In addition, companies that electronically store or transmit such information must ensure that their computer systems meet a number of specific technical requirements that exceed current federal data security regulations and guidance. For more information about these regulations please click here to read our recent Alert.

SEC Seeks Civil Penalties for Failure to Implement Information Security Safeguards

The SEC recently issued an order instituting administrative cease and desist proceedings and imposing remedial sanctions against a broker-dealer that allegedly failed to implement the adequate security controls required by Regulation S-P. According to the SEC's complaint, an internal audit conducted by the broker-dealer in 2006 identified weaknesses in its computer system that increased the likelihood of unauthorized access. Nonetheless, the broker-dealer failed to take corrective action and, during the period from July 2007 through February 2008, unauthorized person(s) breached the broker-dealer's computer system and placed, or attempted to place, 209 trades in 68 customer accounts of the broker-dealer's registered representatives. Although the broker-dealer detected the breaches and absorbed the losses in the customer accounts, the SEC Staff determined that enforcement action was appropriate because the broker-dealer's failure to implement security measures and adopt policies and procedures reasonably designed to safeguard customer information, as required by Regulation S-P, left customer information vulnerable to identity thieves or other unauthorized users. The SEC ordered the broker-dealer to cease and desist from committing any violations or future violations relating to Rule 30(a) of Regulation S-P, and pay a civil money penalty of $275,000.

Bank Depository Instruments Offered by 529 College Savings Program Deemed to be Securities under 1933 Act

On August 18, 2008, the SEC Staff refused to give the no-action relief requested by the Missouri Bankers Association (the "MBA") with respect to certain bank depository instruments proposed to be offered under a Missouri 529 College Savings Program (the "Program"). MBA was denied no-action relief by three separate divisions of the SEC (the Divisions of Corporation Finance, Market Regulation and Investment Management), which noted that the provisions of Section 529 create rights and obligations that are different from bank depository instruments. The Division of Corporation Finance denied assurance that neither the depository instruments being offered under the Program nor a participant's participation interest in the Program are "securities" requiring registration under the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the "1934 Act") or, alternatively, that they are exempt from registration under the 1933 Act and the 1934 Act pursuant to Section 3(a)(2) and Section 3(a)(29), respectively. In conjunction, the Division of Market Regulation declined to state that it would not recommend any enforcement action if the participating banks and their employees administer their described plan without registering as broker-dealers pursuant to Section 15(a) of the 1934 Act. Finally, the Division of Investment Management refused to rule that the Program would not be treated as an issuer of a security and, as such, would not be an investment company as contemplated by the Investment Company Act of 1940 (the "1940 Act").

Federal Reserve Issues New Policy Statement Regarding Ownership of Minority Interests in Banks and Bank Holding Companies

The Bank Holding Company Act ("BHA Act") imposes bank regulatory requirements on any company that "controls" a bank or a bank holding company. As a result, minority investors in banking organizations typically seek to limit their influence over the management and policies of banking organizations so as to avoid being given controlling person status. In 1982, the Federal Reserve Board ("Fed") issued a Policy Statement of Non-Voting Equity Investments by Bank Holding Companies to provide guidance on the factors the Fed will consider when evaluating whether an investor is in control of a banking organization. The Fed recently reviewed its previous decision in this area and concluded it was useful and appropriate to issue updated guidance to investors. Although the Fed continues to believe that the issue of whether a minority investor "controls" a banking institution depends on all the facts and circumstances of each case, its new guidance does provide additional clarity with regard to certain significant control factors, including the following:

1. Director Representation. A minority investor generally should be able to have a single representative on the board of directors or up to two representatives when the investor's aggregate director representation is proportionate to its total interest in the banking organization but does not exceed 25% of the voting members of the board and another shareholder is a regulated bank holding company.

2. Total Equity. Although the BHA does not explicitly refer to non-voting equity interests, the Fed believes that the overall size of an equity investment is an important indicator of control. In the 1982 Policy Statement, the Board set forth the guideline that non-voting equity investments that exceed 25% of the total equity of a banking organization raises issues of whether the owner can exercise control. In the new guidance, the Fed clarified that it would not expect ownership of non-voting shares to result in control if the investor's total equity was less than 1/3 of the total equity of the organization and the investor does not own, hold or vote 15% or more of any class of voting securities.

3. Consultations with Management. The new guidance clarifies the Fed's views on what types of communications between the minority investor and bank management would be consistent with a non-control determination. The Fed indicated that a minority investor can properly communicate with management about a broad range of issues of concern to shareholders, such as changes in dividend policy, raising additional debt or equity, strategic plans, divestments, mergers, acquisitions and management. However, communications by minority investors should not be accompanied by express or implied threats to dispose of shares in the banking organization, or to sponsor a proxy solicitation if the views espoused by the minority investor are not followed.

Other Developments

Since the last issue of our IM Update we have also published the following separate Alerts of interest to the mutual fund/investment management industry:

- Recent SEC Developments on Confidential Treatment of Short Sale Disclosure Filings
- Treasury Establishes Temporary Guarantee Program for Money Market Funds
- Treasury, IRS Announce Relief for Securities Lenders
- SEC Exercises Emergency Authority to Restrict and Monitor Short Selling and to Relax Stock Repurchase Safe Harbor

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