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

SEC Staff Grants No-Action Relief Regarding the Federal Reserve's Asset-Backed Commercial Paper Money Market Fund Liquidity Facility

On September 25, 2008, the Staff of the Securities and Exchange Commission (SEC) Division of Investment Management advised the Investment Company Institute (ICI) that it would not recommend enforcement action under Section 17(a)(2) of the Investment Company Act of 1940 (1940 Act) against a bank for purchasing asset-backed commercial paper (ABCP) from an affiliated money market fund pursuant to the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF). The AMLF was established by the Board of Governors of the Federal Reserve System (Board) on September 19, 2008 to assist money market funds in obtaining liquidity to meet redemptions by enabling them to sell some of their secured assets at amortized cost. Section 17(a) provides generally that it is unlawful for an affiliated person (as that term is defined in Section 2(a)(3) of the 1940 Act) to knowingly purchase from a registered investment company any security or other property. The ICI argued that the AMLF's requirement that eligible borrowers purchase ABCP from money market funds at amortized cost provided investors with adequate protection against the types of abuses that Section 17(a) was intended to prevent. The relief provided by the Staff enables banks to purchase certain types of ABCP from first- or second-tier affiliated money market funds subject to the following conditions: (1) the ABCP to be purchased from a fund is to be determined by the fund's adviser depending on then-current market conditions and redemption needs; (2) such determinations are to be made consistent with the adviser's fiduciary duty to the fund, and in the best interests of the fund's shareholders; and (3) the fund maintains records of these transactions as required by Rules 31a-1 and 31a-2 under the 1940 Act.

SEC Seeks Penalties For Covering Short Sales by Purchases of Newly Offered Shares

The SEC recently filed a complaint in the United States District Court for the Central District of California, seeking civil penalties and injunctive relief against Lion Gate Capital, Inc., and Kenneth Rickel, the sole owner and employee of Lion Gate, for alleged violations of Rule 105 under the Securities Exchange Act of 1934 (Exchange Act). At the time of the alleged violations, Rule 105 prohibited purchases made to cover a short sale in a registered offering if the short sale occurred during the five business days before the pricing of the offering (restricted period). Rule 105 was amended in 2007 to prohibit any purchases of a security in a registered offering, if the buyer has short position in that security during the restricted period (i.e., the purchase is prohibited and does not have to be specifically traced to a covering transaction).

The SEC alleged that the defendants made short sales of securities of various companies that were in the process of offering new shares in public offerings before they were priced in an offering. The defendants then covered the short sales by agreeing to purchase newly offered shares at their offering price, which, due in part to the short sales, was expected to be lower than the price at which the defendants agreed to sell the shares short. In an effort to avoid violating Rule 105, the defendants allegedly placed cross trade orders to simultaneously buy and sell shares of the issuer immediately after the pricing of the offering, thereby giving them a basis to claim that the covering shares were purchased on the open-market after the restricted period expired. The SEC is seeking a permanent injunction barring the defendants from further violations of Rule 105, a disgorgement of all profits resulting from violations of the rule, and civil penalties under Section 21(d)(3) of the Exchange Act.

Auction Preferred Shares Exempted From Meeting 300% Collateral Requirement for Senior Debt Securities

The SEC issued an order on October 2, 2008 granting certain closed-end funds sponsored by Eaton Vance an exemption from Section 18(a)(1)(A) and (B) of the 1940 Act with respect to their outstanding auction rate preferred shares (ARPS). The order allows the funds to temporarily maintain less than the 300% asset coverage required by Section 18(a)(1)(A) and (B) with respect to a senior security which represents an indebtedness, so long as the funds use the proceeds from the issuance of debt to redeem their outstanding ARPS. The funds will be subject to the lower 200% asset coverage test that applies to the issuance of a senior security which is a stock. The order is in effect for a period of two years from the date of issuance. At the end of the two year exemption period, each fund is required to either pay down or refinance the indebtedness to comply with the applicable asset coverage requirements of Section 18(a).

This order was intended as a temporary measure to allow closed-end funds to provide immediate liquidity to holders of ARPS until the funds can establish Liquidity Protected Preferred Shares (which were authorized by the SEC in another recent no-action letter), or some other permanent source of leverage. The SEC noted that the current disruptions in the credit markets, and subsequent failures of ARPS auctions, had imposed hardships on some ARPS holders, many of whom purchased the shares as short-term cash equivalents. The Staff agreed with the applicant that deleveraging was not a practical solution because the funds would be forced to sell assets at substantial discounts in the current market, which would be detrimental to the funds' common shareholders. In addition, the Staff also recognized that prices of the funds' common shares would likely decline to the extent the loss of leverage reduced investment returns.

SEC Penalizes Adviser For Alleged Portfolio Pumping

In a recent administrative order settling an administrative proceeding, the SEC imposed sanctions against an investment adviser, MedCap Management & Research LLC (MMR), and its managing member and sole owner, for violating Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 (Advisers Act) by engaging in so-called "portfolio pumping" activities. As described in the order, portfolio pumping refers to the practice of making trades for the purpose of artificially raising the price of a stock in order to "pump up" the value of fund assets shortly before the end of a performance reporting period.

In this case, MedCap Partners L.P. (MedCap), a hedge fund advised by MMR, experienced severe investment losses which would have resulted in MedCap having to report a 62% quarterly loss. In order to avoid reporting this poor performance, MMR caused an offshore fund, also advised by MMR, to place large orders for thinly-traded shares of a small health care company in which MedCap was heavily invested during the final four trading days of the quarter. The sharp increase in demand for the health care company stock created by these trades placed upward pressure on the price of the stock over the four-day period and had the effect of increasing the price of the stock by 338%. As a result, MedCap was able to report drastically smaller quarterly losses to its investors.

The SEC found that MMR and its owner had violated the antifraud provisions under the Advisers Act in three ways. First, MedCap made a false representation to its investors by attributing the quarterly performance to the performance of its investments, not to the quarter-end trading by the affiliated fund which had inflated the stock price of MedCap's major holding. Second, MMR caused the offshore fund that purchased the stock to pay prices that were above the real market price for the stock, in violation of MMR's duties to the investors in the offshore fund. Third, MMR collected higher management fees from MedCap by inflating the price of the stock. As part of the settlement, MMR and its owner agreed to cease and desist from committing violations of the Advisers Act, and were ordered to pay disgorgement of $61,180.86 – the amount of additional management fees caused by the spike in the stock price. MMR's principal was barred from association from any investment adviser for one year, after which time he may reapply for association, and was ordered to pay a civil monetary penalty in the amount of $100,000.00.

Electronic Filing Mandated for Exemptive Order Applications

The SEC adopted amendments to Rules 101 and 201 of Regulation S-T and to Rule 0-2 under the Investment Company Act to require electronic filing on the SEC's EDGAR system of applications for exemptive relief. The SEC adopted the new rule in order to promote public access to such filings. The new rule will replace the current system where these applications are submitted in paper form and are available to the public only from the SEC's public reference room.

In its adopting release, the SEC noted that commenters raised the issue of whether the rule should be modified to allow applications to be submitted to the Staff in draft form. The ICI comment letter had indicated its belief that the Staff's "willingness to consider exemptive applications in draft form and to grant requests for confidential treatment, when appropriate, is critical to encouraging innovation in the fund industry." The final rule did not include this change and the adopting release reiterated the Staff's policy that it will not, except in the most extraordinary situations, review draft applications. The Staff also noted that any document that is intended as an application for an order under both the 1940 Act and the Advisers Act should be submitted separately under each act. The adopting release also makes clear that, as with other EDGAR submissions, requests for confidential treatment must be made in paper format. The Staff also noted that the Reg. S-T requirement that amendments be filed electronically will also apply to pending applications initially filed in paper. The effective date of the amendments is January 1, 2009.

FTC Delays Enforcement of Red Flags Rule

In our previous IM Update we discussed the FTC identity theft protection "Red Flags" rule that was scheduled to take effect on November 1, 2008. The FTC has subsequently determined that it will delay its enforcement of the rule as to the entities under its jurisdiction by six months, until May 1, 2009, to allow these entities sufficient time to take appropriate care and consideration in developing and implementing their programs.

Other Developments – Since the last issue of our IM Update we have also published the following Alerts that are of interest to the investment management industry:

- *Congress Blocks Offshore Hedge Fund Deferrals – October 6, 2008*
- *Economic Stabilization Act Provisions You May Have Missed – October 10, 2008*
- *New SEC Short Sale Rule Extends and Modifies Emergency Orders – October 17, 2008*
- *SEC Clarifies Intent of New Short Sale Reporting Transition Rules – October 21, 2008*
- *DOL Finalizes Content Requirements for Cross-Trading Policies and Procedures – November 10, 2008*

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