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

SEC Grants No-Action Relief Regarding Use of Best and Worst Performance Information

The Securities and Exchange Commission's (SEC) Division of Investment Management has stated that it would not recommend enforcement action under Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-1(a)(2) thereunder if an adviser included in its marketing materials *unsolicited* information about the five best and worst performing individual holdings in a particular investment strategy. Section 206(4) of the Advisers Act prohibits investment advisers from engaging in any act that is fraudulent, deceptive or manipulative, and Rule 206(4)-1(a)(2) provides that any advertisement that refers to the investment adviser's past specific recommendations which were or would have been profitable constitutes a fraudulent, deceptive or manipulative act, unless the adviser separately furnishes a list of all recommendations made by that investment adviser within the immediately preceding period. The rule is intended to prevent an adviser from "cherry picking," i.e., including its profitable recommendations and omitting the unprofitable ones.

In seeking the no-action relief, the adviser asserted that providing information about a certain number of holdings that contributed most positively to the performance of a strategy, and an equal number of holdings that contributed most negatively to performance, would benefit investors by helping them understand the effect that individual holdings had on the performance of the strategy. The adviser's proposed advertising materials also included a chart showing the average weight of the holdings, the contribution of the holdings to the subject account's return, and instructions on how an investor could obtain more complete information about the methodology used by the adviser to calculate the contribution of each holding to the account's overall performance. The SEC concluded that, subject to certain conditions, the adviser should be allowed to provide its existing and potential clients with information on some, but not all, individual holdings, even if the client or prospect did not make a specific request for such information. The conditions imposed on the relief granted by the SEC are as follows: (1) there is no subjectivity involved in the selection of the best and worst performers that are included; (2) the calculations use consistent weighting for each holding and the number of holdings is consistent from period to period; and (3) the presentation of the information is not misleading. See TCW Group, Inc. SEC No-Action Letter, dated November 7, 2008.

SEC Passes Credit Rating Agency Reforms

On December 3, the SEC passed a new set of rules that will prohibit securities ratings firms from rating a security if the firm, or an affiliate of the firm, took part in structuring the security. The new rules will also prohibit employees working on security ratings from taking part in fee discussions or arrangements and from accepting gifts in excess of $25 from security issuers, underwriters or sponsors. In addition to the measures aimed at avoiding conflicts of interest at ratings firms, the SEC also adopted rules requiring firms to provide more disclosure concerning their ratings. Firms must now provide annual reports that list any ratings "transitions," i.e., upgrades or downgrades of the ratings for each class of credit ratings over one-, three- and ten-year periods and default statistics for securities they rate, even after they withdraw a rating. Additionally, firms must disclose more information regarding their surveillance of the continued creditworthiness of an issuer for which they have issued a rating, and issuer-paid raters (excluding subscriber-based firms) must furnish a random 10% sampling of their rating actions. The new rules also target ratings of structured finance transactions, requiring ratings firms to disclose whether they verified information concerning the assets underlying structured finance products, specify the degree of verification performed and state whether their ratings took into account the quality of the transaction originators. Although the SEC has expressed the view that there is a need for a rule that promotes competition among ratings firms, the commission declined to vote on certain of its other proposed reforms, including a proposal that would have removed minimum credit rating criteria for rated securities to be eligible for acquisition by money market funds. The SEC is also planning to reissue a proposal that would require ratings

firms to disclose the information they use to arrive at their ratings. SEC Chairman Christopher Cox noted that any further reforms will be matters for consideration by the new SEC Chairman selected by the Obama administration after Mr. Cox steps down from the post early next year.

Temporary Exemption from Redemption Rule Granted to Allow Liquidation for Money Market Funds Participating in the Treasury Department's Guarantee Program

On November 20, 2008, the SEC adopted an interim final temporary rule providing exemptive relief under Section 22(e) of the Investment Company Act of 1940 (1940 Act) for money market funds participating in the Treasury Department's Temporary Money Market Guarantee Program (Program). Under Section 22(e), investment companies must pay a redemption request within seven days. This requirement conflicts with the terms of the Program, which requires a participating fund to suspend the right of redemption or postpone the date of payment beyond the seven-day limit, when the fund's market-based share price drops below $1.00 (a "Guarantee Event" under the Program). The temporary exemption resolves this technical conflict by allowing money market funds that must commence liquidation under the Program to temporarily suspend the right of redemption and postpone the date of payment of redemption proceeds.

Only those funds participating in the Program with the Treasury Department that have executed an agreement (Program Agreement) are eligible for this exemption. Further, the exemption only applies if the fund delivers notice to the Treasury Department of a Guarantee Event and has not cured such Guarantee Event, as described in the terms of the Program Agreement. The SEC notes that the Program does not extend past September 19, 2009 and it permits money market funds thirty days to liquidate; therefore, the temporary exemption will expire on October 19, 2009.

OFAC Issues Guidance on Securities and Futures Accounts

The Treasury Department's Office of Foreign Assets Control (OFAC) is responsible for enforcing economic and trade sanctions against targeted foreign countries, terrorists, international drug traffickers and those engaged in activities related to the proliferation of weapons of mass destruction. These laws apply to all U.S. persons, including investment advisers and broker-dealers. OFAC recently published guidance directed to the securities industry (OFAC Guidance). The OFAC Guidance states that before entering into an advisory or brokerage relationship with a client, the adviser or broker-dealer should screen the client against OFAC's Specifically Designated Nationals and Blocked Persons List (SDN List) and maintain adequate documentation of the results of such screening. The OFAC Guidance notes that a strong OFAC Compliance Program consists of procedures which are similar to those found in a brokerage firm's Customer Identification Program (CIP). CIP procedures are required under FinCen regulations for SEC regulated broker-dealers and registered investment companies, but not for investment advisers. Despite the similarities between OFAC and CIP procedures, the OFAC Guidance makes it clear that OFAC's "strict liability" requirements are more extensive than those imposed by the applicable CIP regulations. According to the OFAC Guidance, a broker-dealer or an adviser may, in some circumstances, be required to "look through" the intermediary of an omnibus account to verify the identity and OFAC status of the underlying beneficial owners. OFAC also published separate guidance on possible risk factors that should be considered by firms in the securities industry when implementing the required risk-based approach to determining the effectiveness of an OFAC compliance program.

Massachusetts Delays Enforcement of Information Security Regulations

In our September/October IM Update, we discussed Massachusetts' new data security rule that was scheduled to take effect on January 1, 2009. The Massachusetts Office of Consumer Affairs and Business Regulation subsequently determined that it will delay its enforcement of the rule as to the entities under its jurisdiction until May 1, 2009. In addition, the deadline for obtaining written certifications of compliance from third party service providers is further extended until January 10, 2010.

Other Developments

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

- FOIA Requests Seek Release of All Forms SH Filed with the SEC – November 21, 2008
- Treasury Extends Temporary Guarantee Program for Money Market Funds – November 25, 2008
- First Circuit Authorizes "Primary" Anti-Fraud Liability for "Implied" Statements – December 11, 2008

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