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

## SEC Adopts New Indexed Annuity Rules

On January 8, 2009, the Securities and Exchange Commission (SEC) released the final text of two new rules applying to indexed annuities and other insurance contracts: Rule 151A under the Securities Act of 1933 (Securities Act) and Rule 12h-7 under the Securities Exchange Act of 1934 (Exchange Act). Rule 151A will apply to indexed annuities issued on or after January 12, 2011 and Rule 12h-7 will become effective on May 1, 2009.

Indexed annuities are annuities the returns on which are based on the performance of an underlying securities index. Section 3(a)(8) of the Securities Act exempts "annuity contracts" or "optional annuity contracts" from the definition of "securities" for purposes of federal securities regulation. Since the emergence of indexed annuities in the mid-1990s, their status under Section 3(a)(8) has remained unclear. By adopting Rule 151A, the SEC has excluded most indexed annuities from Section 3(a)(8), and as a result requires such contracts to be treated as securities under federal securities laws. Under Rule 151A, regulated indexed annuities are distinguished from other exempt annuities on the basis of whether the "amounts payable by the insurance company under the contract *are more likely than not to exceed the amounts guaranteed under the contract*." (emphasis added) The SEC's position is based on its interpretation of the standard for determining the scope of the exemption as set forth in various court cases that have ruled on the Section 3(a)(8) exemption. In the SEC's view, the exemption does not apply to indexed annuities because the purchasers of indexed annuities, as opposed to purchasers of other types of annuities, bear some of the investment risk of the returns provided by the contract.

Commissioner Troy Paredes, the sole dissenting Commissioner, argued that the SEC exceeded its jurisdiction by adopting Rule 151A and that the Rule contravened legal precedent supporting Section 3(a)(8)'s exemption of annuity contracts from the Securities Act. Commissioner Paredes argued against the workability of the Rule's "more likely than not" standard, which he stated was overbroad and in application would deny all indexed annuities Section 3(a)(8)'s exemption. He also disagreed with the SEC's methodology of solely focusing on investment risk. The Rule received approximately 4,800 comment letters and substantial criticism by the insurance industry, which opposed the Rule as an unwarranted expansion of federal securities law requirements into what has traditionally been a state regulated product. An insurance industry group has already filed a suit challenging the Rule in the U.S. Court of Appeals for the District of Columbia Circuit.

Rule 12h-7 accompanies Rule 151A. It provides insurance companies exemptive relief from filing reports under the Exchange Act with respect to indexed annuities and other securities registered under the Securities Act. Certain conditions must be satisfied for the exemption to apply. The conditions in part mandate that the issuers must be subject to and supervised by state regulatory agencies, the securities cannot be publicly traded, and the issuers must take reasonable steps to ensure that trading markets for the securities do not develop. The SEC concluded that because the amount of trading in interests in insurance contracts is nominal, Exchange Act reporting requirements "may result in duplicative regulation that is burdensome."

## SEC Grants No-Action Relief Regarding Repurchases of Auction Rate Securities

On January 6, 2009, the SEC Staff granted no-action relief to various financial firms in connection with purchases of certain auction rate securities by such firms from their clients. Pursuant to numerous settlements entered into between the firms and the SEC, FINRA and state regulatory authorities, certain of the firms are required to offer to repurchase illiquid auction rate securities that they had previously sold to their customers. In addition, other firms that had not entered in settlements also sought relief in order to offer liquidity to their customers who own auction rate securities. The relief was requested because the purchases of the illiquid auction rate securities from a firm's customers could result in that firm owning more than 5% or 25% of the preferred stock of a closed-end fund. In such a case, an argument could be made that the firm could be an "affiliated person" under Section 2(a)(3) of the Investment Company Act, in which case the various restrictions on affiliated transactions between the closed-end fund and the fund firm under the Investment Company Act would apply. Furthermore, the purchases by registered investment advisers from client accounts over which they have investment discretion could violate Section 206(3) of the Advisers Act. Section 206(3) requires an adviser to obtain a client's consent when, acting as principal, it purchases securities from a client.

In order to address these issues, the SEC Staff conditioned its relief by imposing a requirement that firms follow an established Voting Protocol and Discretionary Client Protocol. Under the Voting Protocol, if a firm holds more than 25% of the outstanding preferred stock of a fund, then the firm will vote the preferred shares as directed by an independent third party (such as the trustee of a voting trust or a proxy adviser) when voting on: (i) the election of directors to be elected by holders of preferred stock of the fund under Section 18(a)(2)(C), and (ii) matters requiring approval of a majority of such preferred stock pursuant to Section 18(a)(2)(D) of the Investment Company Act. As an alternative Voting Protocol, a firm may adopt and implement a policy always to follow the direction of an independent third party in voting on preferred stock matters (without regard to its percentage ownership of a fund's preferred stock). The Discretionary Client Protocol includes the following requirements, among others: when a firm makes an offer to purchase a client's illiquid auction rate securities, the offer document must disclose that the firm is acting in a principal capacity, will not charge a commission and does not expect to profit from any later resale of the securities. Following the mailing of the offer document, a firm must make reasonable efforts to obtain a client's consent to the sale. If a client does not inform a firm orally or in writing that it has elected not to proceed with the purchase, the firm may proceed with the purchase, but not before the earlier of 45 calendar days after the distribution of the offer document or 15 business days prior to the expiration of the offer. *Davis Polk and Wardwell*, SEC No-Action Letter dated January 6, 2009.

## Off-Shore Courts Rule on Hedge Fund Shareholders' Redemption Rights

In *BNY AIS Nominees Limited & Ors v. Stewardship Credit Arbitrage Fund*, the Supreme Court of Bermuda recently ruled on the question of whether an off-shore hedge fund had validly made in-kind redemption payments to its shareholders, a group of funds advised by Gottex (the Gottex Funds). The Gottex Funds challenged the validity of the in-kind redemption and brought the action in a Bermuda court seeking to have provisional liquidators appointed for the purpose of liquidating the fund, which was formed under the laws of the Cayman Islands. The fund argued that the Gottex Funds did not have standing to bring the petition because the Gottex Funds were shareholders rather than "creditors" of the fund. The fund argued that it had tendered the amount owed for the redemption payments in-kind by delivering certain documents purporting to be "Participation Notes" issued by the fund. The Participation Notes were non-transferable certificates evidencing a beneficial interest in the underlying loans which continued to be held "in trust" by the fund. In the Court's view, in order to constitute a valid in-kind distribution, the following conditions must be met: (i) the distribution must consist of assets which are distributed; (ii) the assets distributed must be assets of the fund; and (iii) the assets distributed must have a value equal to the relevant redemption price. The Court concluded that the Participation Notes failed to meet any of these three requirements and accordingly ruled that provisional liquidators should be appointed for the fund as requested by the Gottex Funds.

A similar case involving a fund liquidation proceeding was also recently decided by the Court of Appeals for the Cayman Islands. In that case, *In the Matter of Strategic Turnaround Master Partnership, Limited*, the plaintiff shareholder gave notice of its redemption request to the fund on October 31, 2007. According to the relevant fund formation documents, the valuation date for the redemption was March 31, 2008 and the redemption amount was payable by the fund on May 1, 2008. The directors of the company suspended redemptions on April 17, 2008. In determining whether the shareholder was a creditor of the fund, the court stated that under Cayman Islands law, a "redeeming shareholder remains a member of the company until he has received payment and his name has been removed from the register of members." The plaintiff claimed that it ceased to be a shareholder on March 31, when its request to redeem all of its interests became effective. The plaintiff contended that the removal of its name from the shareholder list was not significant because such removal was an administrative act entirely within the control of the fund. The court disagreed and ruled that the suspension of redemptions by the fund's directors was effective and prevented the shareholder from changing its status to a creditor of the fund. However, the court allowed the plaintiff to amend its complaint to add allegations supporting its claim that it was entitled to the requested liquidation of the fund on "just and equitable grounds." The Court of Appeals remanded the case to the trial court to allow it to further adjudicate the plaintiffs' alleged just and equitable grounds.

## Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting

The SEC Staff recently issued a study in response to section 133 of the Emergency Economic Stabilization Act of 2008, which mandates a study on mark-to-market accounting standards as provided by the Financial Accounting Standards Board's ("FASB") Statement of Financial Accounting Standards No. 157 ("SFAS No. 157"). SFAS No. 157, issued in 2006, provides a standardized definition of fair value. The SEC's study was conducted in response to claims by critics that fair value accounting standards caused or contributed to the economic crisis because the application of the rule's fair value standards in illiquid markets results in assets being valued below their true economic value.

The SEC's study addresses the effects of fair value accounting standards on financial institutions' balance sheets; the impact of fair value accounting on the 2008 bank failures and the quality of financial information available to investors; the process used by FASB in developing accounting standards; the alternatives to fair value accounting standards and the advisability and feasibility of modifying fair value accounting standards. After considering the issues above, the Staff issued the following recommendations: (1) SFAS No. 157 should be improved because its current guidance does not determine when fair value should be applied and it provides only a common definition of fair value and a common framework for its application; (2) existing fair value and mark-to-market requirements should be maintained given that fair value and mark-to-market accounting has been in place for years and its removal would erode investor confidence in financial statements and that fair value and mark-to-market accounting do not appear to have caused bank failures; (3) additional measures should be taken to improve the application and practice related to existing fair value requirements through the use of best practices guidance for determining fair value in illiquid or inactive markets; (4) accounting for financial asset impairments should be readdressed because U.S. Generally Accepted Accounting Principles do not provide a uniform model for assessing impairments; (5) additional guidance to foster the use of sound judgment should be implemented; (6) accounting standards that meet investors' needs should continue to be established; (7) additional measures to address the operation of existing accounting standards should be adopted given that steps could be taken to enhance the FASB process; and (8) accounting for investments in financial assets should be simplified because it would be useful for investors to have clear disclosure of inputs and judgments made when preparing a fair value measurement.

## Other Developments

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

IRS Releases Further Guidance Affecting Offshore Hedge Fund And Other Pooled Investment Vehicle Deferrals - January 12, 2009

FERC Clarifies that Certain Investments and Investment Adviser Companies Must Receive Prior Approval to Acquire Utility Company Securities – January 26, 2009

SEC Adopts Summary Prospectus Rules for Mutual Funds – January 27, 2009

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