INVESTMENT MANAGEMENT UPDATE

February 2009

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

SEC Adopts New Rules for Credit Rating Agencies

On February 2, 2009, the Securities and Exchange Commission (SEC) adopted certain amendments to the rules governing nationally recognized statistical rating organizations (NRSROs). These amendments are part of an SEC initiative to address concerns over the practices of NRSROs with regard to rating structured finance products, particularly mortgage related securities. The amendments seek to increase transparency by requiring NRSROs to make additional disclosures about the procedures and methodologies used by NRSROs in determining credit ratings for structured finance products and other debt securities. The amendments also impose additional recordkeeping requirements on NRSROs, including the requirement to maintain a complete record of all rating actions taken for each rating issued. The new regulations also require that portions of these new records must be made publicly available. An NRSRO must now provide on its website a random sample of 10% of its issuer-paid credit ratings within six months after the ratings actions are taken. The rule amendments are effective April 10, 2009.

The SEC also proposed or re-proposed additional amendments in a separate release issued the same day. The proposed amendments would require an NRSRO to publicly disclose in XBRL format the credit rating history information for all outstanding issuer-paid credit ratings issued on or after June 26, 2007 within 12 months of the date of the ratings action. The proposed amendments would also require an NRSRO to make available to other NRSROs, through a password protected website, information concerning the structured finance products that are provided by the arranger. In order to obtain such access, the NRSRO would be required to file an annual certification with the SEC and actually make competing credit ratings of at least 10% of the products for which they access information.

Adviser Sanctioned for Manager Selection Advice

On January 30, 2009, the SEC issued an order (Order) imposing remedial sanctions and a cease-and-desist order against Merrill Lynch, Pierce, Fenner & Smith Inc. (Merrill Lynch) pursuant to Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (Advisers Act). In the Order, the SEC found that, from approximately 2002 through 2005, Merrill Lynch employees in its Pension Consulting Services Advisory Program (Program) made material misrepresentations and failed to disclose conflicts of interest to various high net worth and institutional clients. As part of its pension consulting services, Merrill Lynch assisted its clients in crafting investment policies and determining asset allocations. Additionally, Merrill Lynch examined its clients' existing money managers to determine whether the managers' performances met the clients' investment objectives. Merrill Lynch also recommended new money managers to its clients to handle the management of their discretionary accounts.

During the relevant time period, Merrill Lynch's office in South Florida provided clients with materials that described an extensive research and evaluation process it followed when selecting managers for clients. Specifically, these materials stated that the South Florida office would review a client's investment questionnaire detailing his or her investment objectives, compare these objectives with a vast database of money managers and apply various criteria to produce a preliminary list of potential managers. These materials further stated that the consulting services headquarters in New Jersey would review the preliminary list and provide the client with a customized booklet detailing the refined list of appropriate money managers and their backgrounds.

In practice, the South Florida office did not follow this process and instead chose money managers from a pre-existing list of about 60 managers, and often would select managers without using client specific data. In addition, Merrill Lynch recommended money managers that had not been vetted and approved by Merrill Lynch Consulting Services. The reports generated by the Florida office were not reviewed by the headquarters in New Jersey.

The SEC also found that during the relevant time period, Merrill Lynch charged clients in the Program advisory fees on a fixed-fee basis that clients could pay in cash (i.e., "hard dollars") or through a directed brokerage arrangement that generated soft dollar credits for trades executed by Merrill Lynch's brokerage division. Merrill Lynch failed to disclose the following conflicts of interest to Program clients: (i) that they would likely pay less in fees if they did not elect the directed brokerage option and instead executed trades elsewhere and paid only the hard dollar annual fee, (ii) that Merrill Lynch Consulting Services and its investment adviser representatives might have a financial incentive to recommend that its clients enter into a directed brokerage relationship, and (iii) that its Global Wealth Management Group and its investment adviser representatives had a direct financial incentive to recommend that clients use Merrill Lynch for transition management services.

In connection with these violations, the SEC also found that Merrill Lynch failed to adequately supervise its investment adviser representatives with a view to preventing violations of federal securities laws and that Merrill Lynch did not maintain adequate records in willful violation of Section 204 of the Advisers Act and Rule 204-2(a)(14) by failing to maintain a record of the disclosure material that it provided to Program clients. The SEC has censured Merrill Lynch, issued a cease-and-desist order and fined Merrill Lynch in the amount of $1 million for these violations.

Gartenberg Standard Applies to 12b-1 Fees Paid to Fund Distributor for Post-Sales Activities

In an action against the adviser and the distributor of a registered open-end investment company, a federal district court dismissed a shareholder complaint alleging that fees charged to a fund by the distributor for post-sales activities constituted a violation of the distributor's fiduciary duty under section 36(b) of the Investment Company Act of 1940 (Investment Company Act). The plaintiff, a shareholder of an open-end fund (Fund), claimed that the charges for post-sales services were improper because such services cannot be "primarily intended to result in the sale" of the Fund's shares, as contemplated by SEC Investment Company Act Rule 12b-1(a).

The plaintiff argued that she did not need to prove the 12b-1 fees were excessive under the Gartenberg standard because her claims were based on allegations that the fees were improper and unlawful, as opposed to fees that were merely excessive. However, the District Court for the Southern District of California disagreed and stated that the Gartenberg standard does apply, and that the plaintiff failed to allege facts which would support a claim that the fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." The Court concluded that the plaintiff's allegation that the fee was used for an improper purpose is not sufficient to allege a claim under section 36(b), and the defendant's motion to dismiss was granted with leave to amend the complaint to add allegations that the fee is excessive according to the Gartenberg standard. Korland v. Capital Research and Management Co.

Funds will be Required to File in XBRL Format

The SEC recently adopted a rule that will require open-end mutual funds to file a new exhibit to their registration statements containing risk/return summary information in an interactive data format, eXtensible Business Reporting Language (XBRL). Under the proposed rule, each open-end mutual fund would be required to provide the interactive data on its website and to the SEC. 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 that become effective after January 1, 2011. The interactive data submissions could 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 the required risk/return information in an interactive format, the fund's ability to file post-effective amendments will be automatically suspended.

Participations in Subordinate Real Estate Mortgage Loans May Constitute "Qualifying Interests"

Section 3(c)(5)(C) of the 1940 Act excludes from the definition of an investment company issuers that do not issue redeemable securities and that are engaged primarily in the business of "purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." An asset is not deemed to be a "qualifying interest" in real estate if it is an interest in the nature of a security in another person engaged in the real estate business. For this reason, the SEC Staff generally takes the position that an issuer that is engaged primarily in purchasing or otherwise acquiring participations or fractionalized interests in individual or pooled mortgages or deeds of trust is not entitled to rely on Section 3(c)(5)(C). However, an issuer that holds mortgage participation interests may rely on Section 3(c)(5)(C) if the mortgage participation interests have attributes that would classify them as being interests in real estate rather than as being interests in the nature of a security in another person engaged in the real estate business.

In a recent no-action letter the SEC Staff was asked to rule on whether participations in certain "B Notes" constitute interests in real estate. The B Notes are issued in connection with a financing structure in which the principal balance of a loan that is fully secured by a mortgage on commercial real property is divided between two or more mortgage lenders. The senior participation, the holder of the "A Note", has priority over the junior participation, the holder of the B Note, with respect to allocation of payments made on a mortgage loan.

In concluding that B Notes were "interests in real estate," the SEC Staff focused on the following rights and remedies of the holders of the B Notes as being significant: a B Note holder has the right to receive its proportionate share of the interest and the principal payments made on the mortgage loan by the borrower, and the B Note holder's returns are based on such payments; a company that invests in B Notes performs the same type of due diligence and credit underwriting procedures that it would perform if it were underwriting the underlying mortgage loan; the B Note holder has approval rights in connection with any material decisions pertaining to the administration and servicing of the loan and with respect to any material modification to the loan agreements; and in the event that the loan becomes non-performing, the B Note holder has effective control over the remedies relating to the enforcement of the mortgage loan, including ultimate control of the foreclosure process. Capital Trust, Inc. SEC No-Action Letter dated February 3, 2009

Other Developments

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

Senate Bill would Require Registration of Hedge, PE and VC Funds – January 30, 2009

SEC Adopts Amendments to Form N-1A for Exchange Traded Funds – February 2, 2009

Massachusetts Extends Compliance Deadlines for Data Security Regulations Again – February 13, 2009

FINRA Proposes to Regulate Member Private Offerings – February 26, 2009

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