# INVESTMENT MANAGEMENT UPDATE

ROPES & GRAY

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

## SEC Proposes New Rules for Director Nominations by Shareholders

On June 10, 2009, the Securities and Exchange Commission proposed new rules that are intended to remove impediments to the exercise of shareholder rights to nominate and elect directors of certain companies. The new rules would apply to companies subject to the proxy rules[1] under the Securities Exchange Act of 1934 (Exchange Act), including open- and closed-end investment companies registered under the Investment Company Act of 1940 (Investment Company Act). Certain key aspects of the proposed new rules as they apply to registered investment companies are summarized below.

Under new proposed Exchange Act Rule 14a-11, certain shareholders would be able to include their nominees for election as a director in the investment company's proxy materials unless the shareholders are otherwise prohibited, either by applicable state law or a company's charter and/or bylaws, from nominating a director candidate. Shareholders would be eligible to have their nominee included in the proxy materials if they own a certain percentage of the applicable investment company's voting securities. The threshold percentage would vary from between one and five percent depending on the size of the investment company's net assets.[2] Shareholders would be required to have held their shares for at least one year. Shareholders would also be required to file with the SEC and submit to the investment company a new Schedule 14N declaring, among other things, their intent to continue to own their shares through the applicable shareholder meeting and certifying that they are not holding their shares for the purpose of changing control of the company or to gain more than minority representation on the board of directors. Shareholders would only be able to nominate directors that would not be deemed "interested persons" of the applicable investment company for purposes of the Investment Company Act. Shareholders would be able to nominate no more than one nominee, or a number of nominees that represent up to 25 percent of the company's board of directors, whichever is greater. The nominating shareholders may have no direct or indirect agreement with the investment company regarding the nomination of the nominee.

The SEC also proposes amendments to Form 8-K to require that, under certain circumstances, open- and closed-end investment companies make a Form 8-K filing with the SEC in advance of a meeting at which directors are to be elected. If an investment company did not hold an annual meeting during the prior year, or if the date of the meeting has changed by more than 30 calendar days from the prior year, the proposed rules would require the company to file, within four business days of determining the date of an anticipated shareholder meeting to elect directors, a Form 8-K disclosing the date by which a shareholder or group must provide notice on Schedule 14N to the company regarding the shareholder's or group's nominations.[3] With respect to other registered investment companies, a shareholder or group would be required to provide Schedule 14N by the date specified in the company's advance notice provision or, where no such provision is in place, no later than 120 calendar days before the date that the company mailed its proxy materials for the prior year's annual meeting.

In determining whether the applicable net asset threshold described above has been met, the nominating shareholder or group generally would be permitted to rely on information set forth in the following documents: (1) in the case of a series-type company, a Form 8-K that the new rules would require the investment company to file in connection with a meeting at which

[1] The new rules would not, however, apply to companies that are subject to the proxy rules solely because they have a class of debt registered under Section 12 of the Exchange Act.

[2] For registered investment companies that are organized in series form, the proposed net asset thresholds would apply to the company as a whole, and not on a series by series basis.

[3] Although shareholders and groups would be required to submit a copy of the applicable Schedule 14N to the investment company in addition to filing it with the SEC, it may be advisable for investment companies to monitor for Schedule 14N filings made with the SEC by shareholders seeking proxy access.

directors are to be elected;[4] or (2) in the case of other registered investment companies, the company's most recent annual or semi-annual report filed with the SEC on Form N-CSR.

The investment company would be required to include in its proxy materials disclosure concerning the nominating shareholder, as well as the shareholder nominee or nominees. The nominating shareholder or group would be liable for any false or misleading statements in information provided to the company that is then included in the company's proxy materials. The proposed rule would provide that the company would not be responsible for information provided by the shareholder, unless the company knows or has reason to know the information is false.

In addition, the new rules would require, among other things, that an investment company include in its proxy materials, under certain circumstances, shareholder proposals that would amend, or that request an amendment to, the company's governing documents regarding nomination procedures or disclosures related to shareholder nominations, provided the proposal does not conflict with the SEC's disclosure rules—including the proposed new rules. The SEC has requested comments from the public with respect to the proposed new rules. Comments must be submitted on or before August 17, 2009.

## Adviser Sanctioned for Failure to Provide Information to Fund Board

On May 27, 2009, the SEC settled an administrative proceeding against an investment adviser of a registered investment company for violations of Sections 15(c) and 34(b) of the Investment Company Act, and Section 206(2) of the Investment Advisers Act of 1940 (Advisers Act). The fund in question included an unusual guarantee feature, whereby an affiliate of the adviser agreed to make up any shortfall if the value of a shareholder's investment in the fund on the tenth anniversary of his or her investment was less than his or her original investment, provided the shareholder remained in the fund for the entire period and reinvested all distributions. The SEC concluded that the adviser violated Section 15(c) of the Investment Company Act when it asked the fund's Board of Directors to consider the cost of the fund's guarantee feature in the context of the Board's decision to renew the fund's investment advisory arrangements without providing information necessary for the Board to evaluate the guarantee feature's cost or value. Specifically, the adviser did not inform the Board of, among other things: (i) the existence of a reserve on the books of an affiliate of the adviser to cover the expected costs of the guarantee feature, (ii) the amount of that reserve or (iii) the cost of providing the guarantee feature.

In later years, after the adviser had informed the Board of the existence and amount of the reserve, the adviser included the reserve in the profitability analysis it provided to the Board, but did not provide (i) the assumptions used to calculate the reserve amount, (ii) an explanation of why the reserve should be included in the analysis, (iii) information that the reserve represented the present value of all future payments related to the guarantee feature or (iv) information that the cost of the guarantee could have been spread over future years. The SEC determined these omissions violated Section 206(2) of the Advisers Act. The SEC also concluded that the adviser violated Section 34(b) of the Investment Company Act by filing registration statements for the fund that included a statement that there was no charge to investors or the fund for the guarantee feature.

## ETFs Permitted to Use Traditional Active Portfolio Management Strategies

Unlike index-based exchange traded funds (ETFs) that seek to replicate the performance of a particular market index, actively-managed ETFs seek to outperform their benchmarks through active portfolio management. The first actively-managed ETFs were launched in 2008 and invest only in securities included within a specific universe of securities and are limited in the frequency of securities trading (e.g., weekly), or are so-called currency ETFs that invest in a combination of U.S. money market securities with forward currency contracts and currency swaps in order to create a position economically similar to a money market instrument denominated in a non-U.S. currency.

[4] This Form 8-K filing would generally include disclosure as to the company's net assets as of June 30 of the calendar year immediately preceding the calendar year of the meeting and the total number of the company's shares that are entitled to vote for the election of directors at the meeting as of the end of the most recent calendar quarter.

Recently launched and proposed multi-manager and single-manager actively-managed ETFs managed by Grail Advisors use traditional active portfolio management strategies, which is a step forward in the evolution of portfolio management of actively-managed ETFs.

On May 1, 2009, Grail Advisors launched the Grail American Beacon Large Cap Value ETF, which is a multi-manager actively-managed ETF. Each of three investment managers sub-advises the multi-manager ETF. Due to its multi-manager structure, the ETF's portfolio holdings are not necessarily identifiable to a particular sub-adviser, which is intended to protect the ETF and other clients of the sub-adviser against front-running traders. On May 18, 2009, Grail Advisors filed an exemptive application for a so-called manager of managers order, seeking relief from the shareholder approval requirements of Section 15(a) of the Investment Company Act and Rule 18f-2 thereunder. This relief would, subject to certain conditions, permit Grail multi-manager ETFs to hire new sub-advisers and materially amend sub-advisory agreements without shareholder approval.

On June 8, 2009, Grail Advisors ETF Trust filed a post-effective amendment relating to four single-manager actively-managed ETFs. The depth and breadth of the markets in which the single-manager ETFs invest leads the sub-adviser to expect that front-running trading should not be a significant concern. The single-manager ETFs are expected to start trading in September 2009.

## Adviser Reaches Settlements Regarding Portfolio Valuation Issues

An adviser and distributor to a mutual fund complex reached final settlements with the SEC and the Securities Division of the Secretary of the Commonwealth of Massachusetts primarily relating to the liquidation of a fixed income mutual fund that invested substantially in mortgage-backed securities. The claims settled include the following: first, that during the period February 2007 through the fund's liquidation on June 18, 2008, the fund's former portfolio management team failed to properly take into account readily available information in valuing certain non-agency residential mortgage-backed securities held by the fund, resulting in the fund's net asset value (NAV) being overstated during the period; second, that the adviser and distributor acted inappropriately when, in an effort to explain the decline in the fund's NAV, certain information regarding the decline was communicated to some, but not all, shareholders and financial intermediaries; third, that the fund's portfolio management team did not adhere to regulatory requirements when executing cross trades with other affiliated funds; and finally, that the distributor did not preserve certain text and instant messages transmitted via personal digital assistant devices.

## SEC No-Action Letter Allows Registered Funds to Make TALF Investments

The SEC staff granted no-action relief to allow open- and closed-end funds sponsored by Franklin Templeton (the Funds) to participate in the Term Asset-Backed Securities Loan Facility (TALF) without treating borrowings under the program as senior securities representing indebtedness for the purposes of compliance with Sections 18(a)(1), 18(c) and 18(f)(1) of the Investment Company Act and to allow the Funds to participate in the TALF program despite the unique custody arrangements necessitated by the program.

In their no-action request, the Funds indicate that a TALF loan would affect a Fund's capital structure in a manner analogous to the effect of a reverse repurchase agreement because a TALF loan would entail a loan by the Federal Reserve Bank of New York (FRBNY) to a Fund in exchange for the pledge of collateral. In granting no-action relief, the SEC staff highlighted the fact that if the loan is not repaid, the FRBNY generally may enforce its rights only against the collateral and its recourse rights will not extend to the other assets of the Fund. (The staff indicated that the relief would not apply in circumstances where TALF loans become recourse.) The relief requires that the Fund segregate liquid assets in an amount equal to the Fund's outstanding principal and interest on the TALF loan in a manner similar to that set forth in Investment Company Act Release No. 10666 (Apr. 18, 1979) for reverse repurchase agreements. A Fund may not use the "Eligible Securities" that collateralize its borrowing under the TALF program to meet the asset segregation requirement. The value of the segregated assets will be marked-to-market daily and additional liquid assets will be segregated whenever the total value of the segregated assets

falls below the amount of the Fund's obligation under the TALF loan. According to the letter, the combination of the asset segregation requirement and the Eligible Securities collateralizing the borrowing ensures that a Fund's borrowing under the TALF program will, in effect, have asset coverage of at least 200%.

Any funds disbursed by or to a Fund under the TALF program (e.g., all amounts due at the closing of a TALF loan) are disbursed through an account held by a primary dealer as agent for the Fund. As such, the primary dealer will hold Fund assets for a period of time but without compliance with the requirements of Rule 17f-1 under the Investment Company Act. The staff granted no-action relief for these "unique custody arrangements" but did not restate or comment on the Funds' rationale for the relief. The Funds had argued that the custody arrangements would not raise the safekeeping concerns underlying Rule 17f-1 or Section 17(f) and that the primary dealers, which are selected by the FRBNY, facilitate participation in the TALF program and would have limited access to Fund assets.

The no-action request also states that when an asset-backed security subject to a TALF loan is an illiquid security, the Funds will count only the amount by which the fair value of the asset-backed security exceeds the amount of the TALF loan as illiquid for purposes of determining compliance with the Funds' restrictions on investments in illiquid securities. The Funds state that this practice gives effect to the unique non-recourse nature of the TALF loan, which limits the Funds' assets potentially at risk to a particular asset-backed security. The staff did not take issue with or otherwise comment upon this methodology in its response letter.

## 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:

SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser, May 20, 2009

Expansion of Federal Reserve's TALF to include certain CMBS issued prior to January 1, 2009, May 29, 2009

Congress Expands Reach of Major Anti-Fraud Statutes and Authorizes $500 Million to Combat Financial Fraud, May 29, 2009

SEC Proposes Amendments to the Custody Rule under the Advisers Act, May 29, 2009

New FDIC Public-Private Approach To Sales of Loans From Failed Banks, June 1, 2009

Bankruptcy Court Maintains the Status Quo, Allaying Fears of CMBS Industry, June 10, 2009

Update on the Federal Reserve Bank of New York Term Asset-Backed Securities Loan Facility, June 12, 2009

President Obama Proposes New Financial Regulations, including Hedge Fund Registration, June 18, 2009

Foreign Bank & Financial Accounts Reports Due June 30 – Recent Developments, June 19, 2009

Obama Administration Proposes New Executive Compensation Rules, June 19, 2009

Possible Effects on Investment Companies and Investment Advisers of the Administration's Financial System Regulatory Proposal, June 23, 2009

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

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