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 Enhanced Governance Disclosure for Proxy Statements and Registration Statements

The SEC recently proposed amendments to a number of its rules and disclosure forms to enhance the corporate governance disclosures that registrants, including open- and closed-end investment companies registered under the Investment Company Act of 1940 (Investment Company Act), are required to make about director qualifications, past board memberships and legal proceedings, investment company "leadership structure," and the board's role in the risk management process. Certain key aspects of the proposed amendments as they apply to investment companies are summarized below.

The SEC is proposing to expand the disclosure requirements regarding the qualifications of directors by requiring disclosure detailing for each director the particular experience, qualifications, attributes, or skills that qualify that person to serve as a director of the investment company, and as a member of any committee that the person serves on or is chosen to serve on (if known), in light of the investment company's business and structure.

In addition to this expanded narrative disclosure regarding director qualifications, the SEC is proposing two additional changes to its director biographical disclosure requirements. First, the SEC is proposing to require disclosure of any directorships held by each director at any time during the past five years at public companies or investment companies, and second, the SEC is proposing to lengthen the time period during which disclosure of legal proceedings is required from five to ten years.

The SEC is also proposing a new disclosure requirement that would require disclosure of the investment company's leadership structure (including the responsibilities of the board of directors with respect to the investment company's management) and why the directors believe it is the best structure for the investment company, along with additional disclosure about the board's role in the investment company's risk management process.

Under the proposed leadership structure amendments, investment companies also would be required to disclose whether the board chair is an "interested person" of the investment company, as defined in Section 2(a)(19) of the Investment Company Act. If the board chair is an interested person, an investment company would be required to disclose whether it has a lead independent director and what specific role the lead independent director plays in the leadership of the investment company.

These proposals would amend Schedule 14A to apply all of these expanded requirements to investment company proxy and information statements where action is to be taken with respect to the election of directors and would amend Forms N-1A and N-2 to require that investment companies include the expanded disclosures, with the exception of director legal proceedings, in their statements of additional information. All of the expanded Schedule 14A requirements regarding directors would also apply to nominees for director.

The SEC's proposal also includes provisions dealing with enhanced compensation disclosure, new disclosure regarding compensation consultants and amendments relating to the disclosure of shareholder voting results, but these elements do not apply to investment companies. In addition, the SEC proposed amendments to the proxy rules, including those rules applicable to investment companies, to make technical clarifications regarding the manner in which such rules operate and address issues that have arisen in the proxy solicitation process.

The SEC has requested comments from the public with respect to the proposed new rules. Comments must be submitted on or before September 15, 2009.

DC Circuit Halts Implementation of SEC Rule Designed to Regulate Fixed Indexed Annuities

On July 21, 2009, the U.S. Court of Appeals for the District of Columbia Circuit decided the appeal filed in American Equity Investment Life Insurance Co., et al. v. U.S. Securities and Exchange Commission by remanding the case to the SEC for further consideration of Rule 151A, an SEC rule that would have classified most fixed indexed annuities (FIAs) as securities and subjected them to federal regulation, including SEC registration, under the Securities Act of 1933 (1933 Act). The court's decision gives the SEC the option either (i) to re-implement the rule at a later date following a re-consideration of the rule's effect on efficiency, competition, and capital formation, (ii) to explain why the SEC is not required to analyze the rule's effect on efficiency, competition and capital formation, or (iii) to abandon the rule.

FIAs are hybrid financial products that combine aspects of both traditional annuities and securities. Traditional annuities guarantee in advance to the purchaser a particular rate of interest on premiums paid under the annuity contract. With respect to FIAs, however, the rate of return on premiums is calculated based on the performance of a securities index, such as the S&P 500 or NASDAQ, during a prior period. Traditional annuities are regulated under state insurance law, but, pursuant to Section 3(a)(8) of the 1933 Act, are generally exempted from all aspects of regulation under the 1933 Act. Rule 151A would have prevented most FIAs from relying on this exemption, resulting in, among other things, the registration with the SEC of offerings of such FIAs under the 1933 Act. A group of insurers challenged Rule 151A in court on two grounds: first, that the rule improperly excluded FIAs from the Section 3(a)(8) exemption; and, second, that the SEC implemented the rule without considering the rule's effect on efficiency, competition and capital formation as required under Section 2(b) of the 1933 Act.

The court accepted only the latter argument, holding that the rule was "arbitrary and capricious" because the SEC failed to consider the rule's effect on efficiency, competition, and capital formation. In coming to this conclusion, the court stated that the SEC failed, among other things, (i) to disclose a reasoned basis for its conclusion that Rule 151A would increase competition, (ii) to analyze the existing level of competition in the marketplace under the current state law regime with respect to FIAs, (iii) to determine whether, under the existing state regulatory regime, sufficient protections existed to enable investors to make informed investment decisions and sellers to make suitable recommendations to investors, and (iv) to analyze sufficiently whether Rule 151A would promote capital formation.

The court's ruling does not preclude the SEC from eventually implementing Rule 151A. In fact, the court held that the SEC's interpretation of Section 3(a)(8)'s exemption, which would have precluded most FIAs from availing themselves of this exemption, was reasonable, noting that

"[i]n FIAs, as in securities, there is a variability in the potential return that results in a risk to the purchaser" and that "[b]y contrast, a [traditional] annuity contract ... avoids this variability by guaranteeing the [applicable] interest rate ahead of time."

FINRA Proposes Amendments to Compensation Disclosure Requirements for Mutual Funds and Broker-Dealers

FINRA issued Regulatory Notice 09-34 on June 17, 2009 in which it proposed a new rule governing the disclosure of cash compensation paid to broker-dealers for the sale and distribution of investment company shares. Proposed FINRA Rule 2341 would replace NASD Rule 2830, on which it is based. As a practical matter, FINRA rules may affect the content of investment company prospectuses and SAIs, because FINRA forbids broker-dealers from selling or distributing investment company securities unless the investment company prospectus and SAI include the disclosures required by FINRA rules.

Rule 2830(l) currently prohibits broker-dealers from accepting any cash compensation from an "offeror" of investment company shares, including the fund and its investment adviser, administrator, underwriter or any affiliated person, unless the cash compensation is disclosed in the investment company's current prospectus or SAI. The proposed rule redefines the term "cash compensation" and establishes three categories of cash compensation, with different disclosure requirements. The first category of cash compensation is standard "sales charges and service fees." Under Rule 2341(l), prospectuses would need to disclose the standard sales charges and service fees ordinarily paid to broker-dealers for the sale of fund shares. No additional disclosure is required regarding individual broker-dealers who receive the standard sales charges and service fees.

The second category of cash compensation is "special sales charges or service fees." A special sales charge or service fee arrangement is one under which a broker-dealer receives sales charges or service fees in excess of the standard sales charges and service fees. The proposed rule prohibits a broker-dealer from entering into a special sales charges or service fee arrangement on terms not available to all broker-dealers that sell a fund's shares unless the identity of the broker-dealer and the terms of the special sales charge or service fee arrangement are disclosed in that fund's prospectus or SAI.

The third category of cash compensation is any form of cash compensation other than sales charges or service fees. This category of cash compensation is not required to be disclosed in the prospectus or SAI. Each broker-dealer that sells shares of the investment company would need to disclose to every purchaser of shares any cash compensation the broker-dealer received from an offeror of the shares in the previous 12 months in excess of the sales charges and service fees disclosed in the prospectus. The proposed rule includes interpretive guidance that would expand the definition of "cash compensation" to include revenue sharing arrangements and other forms of cash compensation not comprised of sales charges or service fees. The broker-dealer would need to update this disclosure semi-annually and deliver it to new and existing customers or make it publicly available on a website or by telephone.

Several commenters, including the Securities Industry and Financial Markets Association, have pointed out that the proposed rule appears to impose on broker-dealers an obligation to determine whether the compensation arrangements of other broker-dealers are properly disclosed in the investment company prospectus and SAI. Because a broker-dealer typically would not have knowledge of the terms of other broker-dealers' compensation arrangements, it would not know whether the prospectus or SAI was deficient. As a result, broker-dealers may be required to amend their distribution agreements to include a representation from the offeror of the investment company shares that the prospectus and SAI adequately disclose all compensation arrangements as required by this rule. FINRA is reviewing the comments now and may propose a final rule by year end.

SEC Staff Determines that U.S. Fund Ownership Limitations Do Not Apply to Foreign Funds

On August 4, 2009, the SEC staff granted no-action relief allowing certain unregistered foreign investment companies (Foreign Funds) to acquire shares of certain U.S. investment companies (U.S. Funds) registered under the Investment Company Act of 1940 in excess of the limitations imposed by Sections 12(d)(1)(A)(ii) and (iii) of the Investment Company Act. Section 12(d)(1)(A) of the Investment Company Act prohibits an investment company (the "acquiring fund") and any companies controlled by such investment company from purchasing or otherwise acquiring any security issued by any other investment company (the "acquired fund") if, immediately after the purchase or acquisition, the acquiring fund and any companies controlled by such fund own in the aggregate: (i) more than 3% of the outstanding voting shares of the acquired fund, (ii) shares issued by the acquired fund having an aggregate value in excess of 5% of the value of the total assets of the acquiring fund, or (iii) shares issued by acquired funds having an aggregate value in excess of 10% of the value of the total assets of the acquiring fund. Section 12(d)(1)(B) generally prohibits an acquired fund from selling securities to any acquiring fund or a company controlled by the acquiring fund if the sale will cause (i) the acquiring fund (and its controlled companies) to own more than 3% of the outstanding voting securities of the acquired fund, or (ii) more than 10% of the acquired fund's voting securities to be held by investment companies generally.

The Foreign Funds sought to purchase securities of the U.S. Funds in excess of the Section 12(d)(1)(A)(ii) and (iii) limitations. The U.S. Funds represented that the Foreign Funds will not offer or sell their securities in the United States or to any U.S. person and that the Foreign Funds' transactions with their shareholders would be consistent with the definition of "offshore transactions" in Regulation S (i.e., the Foreign Funds would not target identifiable groups of U.S. citizens abroad, such as members of the U.S. armed forces). In addition, the request letter represented that the Foreign Funds would comply with Section 12(d)(1)(A)(i) of the Investment Company Act and each U.S. Fund would comply with Section 12(d)(1)(B) of the Investment Company Act.

The U.S. Funds asserted that Congress, when enacting the Section 12 limitations, sought to prevent an acquiring fund from obtaining voting control over an acquired fund and to prevent an acquiring fund from unduly influencing an acquired fund through the threat of large-scale redemptions. The U.S. funds argued, and the SEC staff agreed, that the 3% limitation on the purchase or sale of an acquired fund's shares contained in Sections 12(d)(1)(A)(i) and 12(d)(1)(B)(i) addresses these concerns. Congress' other concerns, namely the layering of sales charges and costs and the difficulty of investors appraising the true value of their investment due to the complex structures involved in fund of funds investments, only affect the interests of the acquiring fund and its shareholders. The U.S. Funds argued, and the SEC staff agreed, that because the acquiring funds are unregistered foreign funds that will not offer or sell their shares in the United States or to U.S. persons, and that the transactions will be consistent with Regulation S, the SEC has no significant interest in protecting the acquiring funds and their shareholders from these potential abuses. Therefore, the SEC staff stated that, based on the U.S. Funds' representations, it would not recommend enforcement action if the Foreign Funds purchased securities issued by the U.S. Funds in excess of the limitations imposed by Sections 12(d)(1)(A)(ii) and (iii).

Massachusetts Proposes Changes to Identity Theft Regulations

The Massachusetts Office of Consumer Affairs and Business Regulation announced further proposed amendments to the Massachusetts' identity theft regulations (201 CMR 17.00). Under the proposed regulations, the Massachusetts requirements would incorporate "risk based" and "technology neutral" standards in determining the security measures that are required and technologies that must be included in an information security program. The troublesome third party verification requirements have also been deleted. The changes are intended to lighten the regulatory burden on small business that do not "own or license" personal information and align the Massachusetts requirements more closely with existing FTC information security rules. However, the proposed Massachusetts regulations are still more specific than the FTC regulations with regard to encryption requirements. The compliance date under the proposed regulations is extended to March 1, 2010. A hearing on the new regulations is scheduled for September 22.

SEC Issues New Final Reg. S-AM

The SEC has issued a new Regulation S–AM to implement Section 624 of the Fair Credit Reporting Act as amended by Section 214 of the Fair and Accurate Credit Transactions Act of 2003 (FCRA). As required by FCRA, the new rule, in certain limited situations, generally prohibits certain persons covered by the rule (covered persons) from making marketing solicitations to consumers based on certain "eligibility information" the covered person receives from an affiliate unless the covered person provides the consumer with notice and the opportunity to opt-out from such solicitations. Reg. S-AM, which was originally proposed in 2004, defines the term "eligibility information" to mean "any information, the communication of which would be a consumer report, if the statutory exclusions from the definition of 'consumer report' in Section 603(d)(2)(A) of the FCRA, for transaction or experience information and for 'other' information that is subject to the affiliate-sharing notice and opt out, did not apply." Section 603 of the FCRA defines the term "consumer report" to mean any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or in part for the purpose of serving as a factor in establishing the consumer's eligibility for: (A) credit or insurance to be used primarily for personal, family, or household purposes; (B) employment purposes; or (C) any other purpose authorized under section 604 of the FCRA [§ 1681b]. The SEC explicitly refused to follow commentators' suggestions to provide examples of this type of information or make this definition easier to apply. Reg. S-AM will become effective on September 10, 2009 with a compliance date of January 1, 2010.

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:

Lehman Brothers Bankruptcy: Bar Date – July 6, 2009.

SEC Acts on Proxy Disclosure and Voting Issues – July 6, 2009.

SEC Proposes Money Market Reforms – July 7, 2009.

SEC Proposes Rule Amendments Affecting Executive Compensation, Director Qualifications and Proxy Solicitation – July 17, 2009.

Treasury Proposes Legislation on Say-on-Pay and Compensation Committee Independence – July 17, 2009.

House Proposal Could Regulate Private Fund Compensation – July 30, 2009.

House Approves Legislation Regulating Financial-Institution Compensation and Requiring Say-on-Pay and Compensation Committee Independence – August 3, 2009.

SEC Proposes Rule Addressing "Pay to Play" Practices Involving Investment Advisers – August 6, 2009.

IRS Extends Certain FBAR Filing Deadlines to June 30, 2010 – August 7, 2009.

SEC Announces New Enforcement Initiatives – August 10, 2009.

U.S. Treasury Proposes Bill for Increased Federal Regulation of OTC Derivatives – August 14, 2009.

FINRA Announces New Registration Requirements for Investment Bankers – August 14, 2009.

Massachusetts Proposes Amendments and a Further Extension of the Compliance Deadlines for Data Security Regulation – August 20, 2009.

FDIC Adopts Qualifications on Private Equity Investors Bidding for Failed Banks – August 27, 2009.

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