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

Donohue Highlights Areas For Director Vigilance in IDC Keynote Speech

Andrew J. Donohue, director of the SEC's Division of Investment Management, gave the keynote address at the Independent Directors Council Investment Company Directors Conference held on November 12, 2009. Mr. Donohue covered a variety of topics during his address, including expense recapture arrangements, steps taken by closed-end funds to defend against shareholder activists, fund mergers, fulcrum fees and managed distribution plans. Mr. Donohue noted that these examples had been identified by the SEC staff and highlight situations where independent directors/trustees should remain vigilant in ensuring that funds are operated in the best interests of shareholders.

Addressing expense recapture arrangements, Mr. Donohue described a situation in which an adviser determines that it will not be able to recapture expenses after the first year because the fund's expense ratio will be above the fund's expense cap. According to Mr. Donohue, concerns arise if the adviser thereafter requests that the fund increase the expense cap so it is greater than the current expense ratio, thereby allowing the adviser to recapture fees waived from the previous period. Mr. Donohue stated that the SEC staff's position has been that in order for advisers to recapture fees, the recapture must be done in accordance with the original recapture plan (i.e., the adviser may only recapture fees to the extent the fund's expense ratio is below the original cap).

Mr. Donohue also discussed his concerns with several of the tactics used by closed-end funds in an attempt to thwart shareholder activists. While acknowledging that closed-end fund boards may take these steps to protect the interests of long-term shareholders against the interests of shareholder activists, he expressed concern with several of these measures, in particular the use of "poison pills" and opting into state "anti-takeover" statutes. While acknowledging that a federal district court has found that a fund's use of serial "poison pills" and opting into the Maryland Control Shares Acquisition Act did not violate the Investment Company Act, he nevertheless expressed his view that the use of these tactics raises serious issues under Sections 18(d) and 23 of the Act. He also expressed concerns about other defensive techniques, such as the selective imposition of trustee qualifications, delaying annual meetings, and requiring a majority vote to elect trustees.

Moving to the topic of fund mergers, Mr. Donohue noted that independent directors/trustees should probe deeply into management's rationale for proposing fund mergers. In particular, he expressed concerns about mergers which appear intended solely to eliminate funds with poor performance. He also expressed concerns about mergers of closed-end funds whose shares trade at a discount, stating that in some cases the shareholder of the acquired fund may be better off if the fund liquidates at net asset value.

When discussing fulcrum fees, Mr. Donohue noted that a fund should not implement a total fee floor that eliminates the possibility that an adviser will have to make a payment to the fund (effectively a negative management fee) when there is a precipitous decline in assets combined with poor fund performance. Such arrangements, he argued, limit the downside to an adviser without proportionally limiting the adviser's upside. Although Mr. Donohue did not address the permissibility of a circumstance where an adviser

implements both a total fee floor and a corresponding total fee ceiling, we understand that others on the staff have expressed concerns with such arrangements.

Finally, Mr. Donohue discussed fund yields and managed distribution plans, noting that the SEC has observed various instances where notice disclosures pursuant to Rule 19a-1 under the Investment Company Act conflict with other information regarding yields posted on a fund's website. He cited these discrepancies as underscoring the need for a fund to monitor its website and ensure that any disclosure inconsistencies are properly explained. In addition, some investors who hold a beneficial interest in a fund through a financial intermediary do not receive Rule 19a-1 notices, which Mr. Donohue identified as another issue that boards should monitor.

While Mr. Donohue's remarks did not mention the possibility of new regulatory action to address his concerns, funds and their boards should be aware that these topics are likely to draw the attention of the staff.

SEC Approves Model Privacy Notice Form

The SEC and other federal regulatory agencies recently issued a final rule release (Investment Company Act Release No. 28997) adopting a model privacy notice form (Form S-P) for financial institutions to use to comply with the notice and disclosure requirements under Regulation S-P, which implements privacy provisions of the Gramm-Leach-Bliley Act. Use of the model Form S-P will provide a safe harbor for compliance with the notice, content, and opt-out requirements of Rules 6 and 7 of Regulation S-P, although use of the model privacy form is not mandatory. Financial institutions may continue to use other types of notices that vary from the model, provided that these notices comply with Regulation S-P. In addition, the Sample Clauses in Appendix B to Regulation S-P and the related guidance regarding their use will be removed from Regulation S-P after December 31, 2010. Thereafter, financial institutions may continue to use the Sample Clauses in their privacy notices, provided they comply with Regulation S-P; but, such privacy notices would not qualify for the safe harbor that is available when the model Form S-P is used. The model Form S-P may also be used to comply with the affiliate marketing notice, content, and opt-out requirements under newly adopted Regulation S-AM (extended compliance date of June 1, 2010), although the model Form S-P requires that any affiliate marketing opt-out granted in connection with use of Form S-P must be for an indefinite period of time (rather than the 5 year limited out-out period permissible under Regulation S-AM).

Additional Credit Rating Agency Reforms Published

In November, the SEC adopted several amendments to certain rules governing NRSROs and proposed a number of additional amendments. Rule 17g-2 under the Securties Exchange Act of 1934 (Exchange Act) was amended by adding a new paragraph (d)(3), which requires an NRSRO to disclose the ratings histories for all ratings initially determined on or after June 26, 2007. This amendment applies to all ratings, regardless of whether they are paid for by the issuer, underwriter, or sponsor of the security being rated ("issuer-paid") or not. The ratings histories for issuer-paid ratings must be updated within 12 months of any ratings action, and the ratings histories for ratings that are not issuer-paid must be updated within 24 months of any ratings action. The SEC also adopted amendments to paragraphs (a) and (b) of Rule 17g-5 under the Exchange Act that impose additional duties on an NRSRO hired by an issuer, underwriter or sponsor (an "arranger") of a structured finance product to determine an initial credit rating for that security. The purpose of these amendments is to provide other NRSROs an opportunity to issue unsolicited credit ratings for such securities, using the same information as the hired NRSRO. The hired NRSRO must disclose to certain other NRSROs, through a password-protected web site, that the arranger is in the process of determining a credit rating for that security. In addition, the hired NRSRO must obtain representations from the arranger that it will provide to certain other NRSROs the same information given to the hired NRSRO in connection with the determination of the initial credit rating ("arranger information").

In order for other NRSROs to gain access to the password-protected websites and to receive arranger information, they must meet certain requirements. Revised paragraph (e) of Rule 17g-5, requires an NRSRO that seeks to

receive arranger information to certify annually to the SEC that it is accessing such information for the sole purpose of determining credit ratings. In addition, the certifying NRSRO must determine and publish unsolicited credit ratings for 10 percent of the securities for which it has received arranger information. The SEC also amended Rule 100(b)(2)(iii) of Regulation FD to permit the disclosure of arranger information to an NRSRO even when the NRSRO may not issue a publicly available credit rating on the related security. The rule amendments adopted in this release are effective February 2, 2010, and the compliance date is June 2, 2010.

The SEC also proposed an amendment to Rule 17g-3 that would require each NRSRO to file with the SEC an annual compliance report signed and attested to by the NRSRO's designated compliance officer. The SEC is also proposing an amendment to Form NRSRO that would require a credit rating agency seeking to register as an NRSRO, or an NRSRO filing its annual update, to disclose (i) the percentage of the net revenue of the applicant/NRSRO attributable to the 20 largest users of its credit rating services and (ii) the percentage of net revenue of the applicant/NRSRO attributable to other services and products it provides. In a related proposal, the SEC proposed a new Rule 17g-7 that would require each NRSRO to publish an annually updated report on its web site describing the revenues earned by the NRSRO and its affiliates from persons that paid the NRSRO to issue or maintain a credit rating. Every time an NRSRO subject to this disclosure requirement issues a credit rating, it would need to include a disclosure statement indicating where on its web site this report is located. Comments on the proposed rule and rule amendments are due February 2, 2010.

The SEC deferred action on a proposed rule that would require NRSROs to include with each credit rating issued for a structured finance product a report describing how the procedures, methodologies and risk characteristics of structured finance products differ from other types of rated instruments.

SEC Permits Funds to Invest in Affiliated Pooled Investment Vehicle to Access TALF Program

The SEC staff granted T. Rowe Price Associates, Inc. (T. Rowe Price) no-action relief on October 8, 2009 to allow certain funds advised by T. Rowe Price (collectively, the "Funds") to purchase interests in an affiliated pooled investment vehicle (the "Private Fund") for the purpose of acquiring eligible collateral and obtaining loans under the U.S. Treasury's Term Asset-Backed Securities Loan Facility (TALF) without obtaining an exemptive order. Under the TALF program, the Federal Reserve Bank of New York provides non-recourse funding through loans to eligible borrowers that post eligible collateral. According to the request letter, the use of the Private Fund to access the TALF program raised "principal transaction" concerns under Section 17(a) of the Investment Company Act and "joint transition" concerns under Section 17(d) of the Act and Rule 17d-1 thereunder. In granting the no-action relief, the SEC staff explicitly limited the relief to T. Rowe Price and stated that it could not be relied on by third parties.

Amendments to New York Stock Exchange (NYSE) Corporate Governance Standards

The SEC recently approved amendments to the NYSE's corporate governance standards for listed companies. Although certain of the amendments create ambiguities for funds listed on the NYSE, we have confirmed the interpretations below with the NYSE.

Highlights of the amendments applicable to closed-end funds include:

- Eliminating the requirement that a closed-end fund disclose in its annual report that (i) its CEO submitted the annual certification regarding corporate governance to the NYSE and (ii) its CEO and CFO submitted certifications regarding financial statements as required by the SEC.
- Requiring that the CEO of a closed-end fund must notify the NYSE in writing after any executive officer of the fund becomes aware of any non-compliance with the NYSE's corporate governance standards in Section 303A of the Listed Company Manual (until the effective date of the amendments, the requirement extends only to "material non-compliance").

- Clarifying that an audit committee charter must require the audit committee to meet to discuss with management both annual and semi-annual financial statements, as well as MDFP (to the extent included), prior to their publication.
- Clarifying that a closed-end fund must disclose in its proxy statement or on its website (i) if an audit committee member serves on the audit committees of more than three public companies and (ii) the board's determination that such service does not impair the member's ability to serve effectively in such capacity. Also, the amendments clarify that service on multiple audit committees in the same fund complex counts as service on one audit committee for these purposes.
- Requiring certain technical amendments to a closed-end fund's audit committee charter.
- Changing the rules relating to website disclosure.
- Requiring shareholder approval of equity compensation plans (which are unlikely to affect most closed-end funds).

The effective date for the amendments is January 1, 2010. However, the NYSE confirmed informally that the NYSE has no expectation that any action requiring Board approval will be taken out of each closed-end fund's regular meeting schedule (e.g., required amendments to the fund's audit committee charter may be made at the first regularly scheduled meeting following January 1, 2010). In addition, depending on a closed-end fund's practices, we would expect that only minor changes (if any) will be required for closed-end funds by that date; however, it may be prudent to plan now for the action items that will be required for the next Board and audit committee meetings or for an upcoming shareholder report or proxy statement.

Additionally, the amendments also include changes that specifically affect business development companies and exchange-traded funds, including certain of the changes listed above for closed-end funds. Those amendments have the same January 1, 2010 effective date.

The text of the amendments to the rules can be found here. The text of the SEC's order approving the amendment to the rules can be found here.

Dark Pool Regulations Proposed

The SEC proposed amendments to its rules under the Exchange Act that apply to non-public trading interest in National Market System (NMS) stocks. These rules have been used by certain market participants to establish so-called "dark pools." Trading with such pools is considered non-public, or "dark," primarily because it is not included in the consolidated quotation data for NMS stocks that is used to widely disseminate stock price information to the public. The non-public trading mechanisms in the SEC's current regulations are intended to help market participants that make large trades, such as institutional investors. These investors want to minimize their transaction costs by completing their trades without prematurely revealing the full extent of their trading interest to the market. As electronic trading systems have expanded, the level of trading activity taking place in dark pools has also grown, and is now a significant percentage of overall market activity. The large amount of trading taking place outside of the consolidated quotation data for NMS stocks raises a variety of important policy issues for the SEC. One such issue is that the actionable indications of interest (IOIs) which are like "quotes" but are privately transmitted by dark pools to solicit trade orders from selected market participants, have the potential to create a market with "two-tiered access to information." The proposed regulations would seek to address this potential problem by amending the definition of "bid" or "offer" in the Exchange Act's quoting requirements to apply expressly to IOIs. The proposed definition would exclude, however, IOIs for large orders that are transmitted in the context of a targeted size discovery mechanism. The SEC is also proposing amendments to the display obligations of alternative trading systems (ATSs) in Regulation ATS under the Exchange Act, including a substantial lowering of the trading volume threshold in Regulation ATS that triggers public display obligations for ATSs.

Third, the SEC is proposing to amend the joint-industry plans for publicly disseminating consolidated trade data to require real-time disclosure of the identity of dark pools and other ATSs of the reports of their executed trades. Comments on the proposed regulations are due on February 22, 2010.

European Commission Sends Statement of Objections to Standard & Poor's Regarding Its Licensing Fees for ISINs

The European Commission sent a Statement of Objections to Standard & Poor's on November 16, 2009, setting forth its preliminary conclusion that S&P's conduct with respect to end users of International Securities Identification Numbers (ISINs) constitutes an abuse of its monopoly position. ISINs are codes used to uniquely identify specific securities issues and are similar to CUSIP numbers used in the United States. This ruling follows a decision made by the European Commission in January of 2009, to open formal proceedings with respect to S&P for possible breaches of the European Commission Treaty's rules on abuse of a dominant market position (Article 82), in response to a complaint filed by several associations representing financial institutions and asset managers. These "end users" alleged that S&P was abusing its monopoly position as the US national numbering agency (NNA) by forcing financial institutions (such as banks and investment funds) to pay licensing fees for the use of US ISIN codes in their own databases. The Commission compared S&P practices unfavorably to other NNAs that do not charge fees, or do so only on the basis of their distribution costs. S&P has eight weeks to reply to the Statement of Objections and has the right to an oral hearing to present its comments on the case. While the Statement of Objections is a formal step in European Commission antitrust investigations, it does not prejudice the final outcome of the procedure. However, if its preliminary findings are confirmed, the Commission may require S&P to cease this business practice and may impose a fine.

The European Commission action can be contrasted with a recent announcement by the Department of the Treasury, Bureau of the Public Debt (BPD),which on November 5, 2009, issued a Special Notice of its intent "to award a sole source contract to Standard and Poor's...to obtain issued CUSIP numbers, the standardized descriptive methodology utilized throughout the financial community for identifying securities." S&P's licensing fees are not discussed in the BPD Special Notice.

Other Developments

Since the last issue of our IM Update, we have also published the following separate client alert of interest to the investment management industry: Directors of Banking Organizations Face Special Liability Risks (December 8, 2009).

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