Investment Management Industry News Summary - September 2000

SEPTEMBER 1, 2000

This Summary, which draws from a wide range of sources, endeavors to condense important investment management regulatory news of the preceding week into one, easily digestible source. This Summary is not intended as legal advice. Readers should not act upon information contained in this Summary without professional legal counsel. This Summary may be considered advertising under the rules of the Supreme Judicial Court of Massachusetts.

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CFTC Rule 4.7 Expanded to Encompass New QEPs

September 25, 2000 10:34 AM

A regulatory framework for commodity pool operators ("CPOs") and for commodity trading advisors ("CTAs") was passed with both substantive and technical revisions to CFTC Rule 4.7. These highly accredited persons formerly called "qualified eligible participants" and "qualified eligible clients" will now be termed "qualified eligible persons" ("QEPs").

New TC Rule 4.7 would expand the available exemptions to the disclosure, reporting and recordkeeping requirements for CPOs and CTAs. The expansion would include in the definition of a QEP: principals of the registered investment professionals who themselves are defined as QEPs; certain registered securities investment advisers and their principals; "qualified purchasers" and "knowledgeable employees;" certain employees and agents of pools, CPOs and CTAs and certain of those employees' and agents' immediate family members; and, trusts whose advisors and settlors are qualified eligible persons. Certain charitable organizations, trusts and collective investment vehicles would benefit by being able to more easily be characterized as a QEP. Furthermore, persons who are not "United States persons" will now be included in the qualified eligible person definition for both exempt pools and exempt accounts under CFTC Rule 4.7.

Not only was CFTC Rule 4.7 reorganized to better clarify the application of the rule, but also technical revisions were made to related rules, in order to reflect the new structure and wording of 4.7.

Exemption from Certain Part 4 Requirements for Commodity Pool Operators With Respect to Offerings to Qualified Eligible Persons and for Commodity Trading Advisors With Respect to Advising Qualified Eligible Persons.

Qualified Employees Satisfied "Knowledgeable Employees" Requirement. The CFTC's Division of Trading and Markets recently provided exemptive relief to a registered CPO seeking to treat five of its non-qualified eligible participant investors, who were employed as analysts by the manager of the fund operated by the CPO, as if they satisfied the QEP criteria of CFTC Rule 4.7(a). The Division of Trading and Markets considered the investors "knowledgeable employees" as defined by Rule 3c-5 under the 1940 Act.

CFTC Staff Letter 00-81.

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Internal Revenue Service ("IRS") Issues Formal Guidance on Deductibility of B Shares Commissions

September 25, 2000 10:27 AM

The IRS recently issued Revenue Procedure 2000-38, which provides electing mutual fund distributors with certainty that the IRS will not challenge the deductibility of commissions paid on the sale of mutual fund shares for which the distributor receives a distribution fee and, in some cases, a contingent deferred sales charge from the investor in future taxable years (commonly referred to as "B shares") through December 31, 2000 and will not impose any adjustment for prior years. The guidance does not affect the deductibility of commissions paid on mutual fund shares for which the distributor receives a distribution fee and, in some cases, a contingent deferred sales charge in future taxable years and will make commission payments to the selling broker in an amount equal to the amount it receives each year that the shares remain outstanding (commonly referred to as "C shares").

The Revenue Procedure provides for capitalization of commissions paid by electing distributors on all sales of B shares that occur after December 31, 2000. All sales through the end of 2000 will remain fully deductible (i.e., with no section 481 adjustment). Unamortized amounts will be accelerated if a distributor's right to the 12b-1 income stream is securitized. Distributors will be permitted to elect, separately with respect to B shares sold for each fund, one of three amortization methods:

Method 1: The 5-Year Method

Under the 5-year method, a taxpayer must capitalize distributor commissions paid or incurred during the taxable year and amortize those amounts ratably over a 5-year period. Amortization for a short taxable year is based on the number of months in the short taxable year (taking into account the half-year convention).

Under this method, a taxpayer must establish one or more pools of commissions. All commissions related to a class of shares of a mutual fund sold in a single taxable year must be in the same pool. A pool of distributor commissions may contain commissions related to classes of mutual fund shares from one or more mutual funds, provided the distributor commissions for each of the classes of mutual fund shares are accounted for using the 5-year method.

While a taxpayer on the 5-year method may not accelerate recovery of remaining unamortized commissions with respect to redeemed shares, the taxpayer may claim a loss or an offset against sales proceeds for unamortized amounts in the pool if the taxpayer experiences a termination event such as securitization or a conversion into another class of shares for which the taxpayer is not entitled to receive a distribution fee- with respect to the distribution fees related to all the shares in a pool. In addition, the Revenue Procedure permits recovery for sales of an undivided interest in its right to all present and future distribution fees for all the shares in a pool in proportion to the interest sold (i.e., proportionate amortization for partial securitizations).

Method 2: The Distribution Fee Period Method

Under the distribution fee period method, a taxpayer must capitalize distributor commissions paid or incurred during the taxable year and amortize them ratably over the period for which the taxpayer is to receive a distribution fee for the sale of those shares (i.e., before the shares "flip" to A shares). Accelerated basis recovery of remaining unamortized commissions with respect to redeemed shares is permitted under this method, as well as with respect to a termination event such as a securitization. Details for basis recovery, in particular as they coordinate with pooling methods, are provided in the Revenue Procedure. Amortization for a short taxable year is based on the number of months in the short taxable year (taking into account the half-year convention).

Under this method, a taxpayer may establish one or more pools of commissions of a class of shares of a mutual fund sold in a single taxable year. A pool of distributor commissions may contain commissions related to a class of mutual fund shares sold in a single taxable year from one or more mutual funds, provided the distributor commissions for each class of mutual fund shares is accounted for under the distribution fee method. A pool may only include commissions related to a class of mutual fund shares sold in a single taxable year with the same distribution fee period and the same compensation structure.

Method 3: The Useful Life Method

Under the useful life method, a taxpayer must capitalize distributor commissions paid or incurred during the taxable year and recover those amounts over their useful life, a period established by taking into account all the facts and circumstances, including the period during which the taxpayer is to receive distribution fees and the experience of the taxpayer regarding how long a typical share remains outstanding after purchase. Useful life method taxpayers may establish one or more pools of commissions, provided that a half-year convention is used to compute the amount of the amortization deduction.

A taxpayer on the useful life method may or may not be able to claim a loss for the unamortized portion of a distributor commission as a result of retirement of shares, depending on whether the useful life method employed is an average useful life that already reflects projected retirements. Proportional or full securitization recovery is permitted, however, provided that the securitization relates to all the shares in a given pool.

Distributors electing to follow the useful life method do not need pre-approval for their method for determining the useful life of B shares or the rate of recovery. Under the guidance, however, the IRS reserves the right to audit a distributor's useful life calculation.

Timing of Election

Elections into the Revenue Procedure - pursuant to filing a Form 3115 and, if the taxpayer is currently under audit on this issue, signing a closing agreement - must be made on or before April 2, 2001. Distributors that do not elect to be subject to the Revenue Procedure will remain subject to audits and adjustments, both retroactively and prospectively. A taxpayer may change among amortization methods described in the Revenue Procedure, or from pooling to single asset methods under the distribution fee period method or the useful life method, provided that such change be made in accordance with the automatic change in method of accounting provisions in Rev. Proc. 99-49.

Internal Revenue Bulletin2000-40, dated October 2, 2000 (advance copy).

attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

District Court Relies on Special Committee in Dismissing Derivative Suit Against Adviser and Directors

September 25, 2000 10:13 AM

The U.S. District Court for the Southern District of New York recently decided that a special litigation committee properly recommended dismissal of a shareholder's derivative claims against a mutual fund's investment adviser, its directors, and other defendants associated with a failed rights offering. The court found no reason to upset the committee's decision that the continued prosecution of the derivative action was not in the best interest of the fund or its shareholders.

The plaintiff filed suit in 1997 against the fund, its investment adviser, and various individual defendants, claiming they violated certain provisions of the Investment Company Act of 1940 (the "1940 Act") and breached fiduciary obligations in connection with a 1996 rights offering. In the offering, the fund's existing shareholders were given the opportunity to purchase additional newly issued fund shares at a discount from market value. The plaintiff contended that the offering constituted a breach of duty by the adviser and the fund's directors because the offering:

- diluted shareholders' investments,
- imposed undue transaction costs on the fund, and
- was motived by a desire to increase the advisory fees rather than to benefit shareholders.

The court previously dismissed the plaintiff's class claims, but rejected motions to dismiss the derivative suit and allegations of control person liability under the 1940 Act. Specifically, the, the remaining claims included:

- breach of fiduciary duty against all defendants under Section 36(a) of the 1940 Act and Maryland common law, and
- control person liability under Section 48(a) of the 1940 Act

Granting the defendants' motion to terminate the derivative action, the court explained that a special litigation committee has the power to terminate a derivative action to the extent allowed by the state of incorporation (in this case, the fund was incorporated in Maryland). According to the court, in Maryland, a committee of disinterested and independent directors may move to terminate a pending shareholder derivative suit that the committee determines in good faith to be contrary to the corporation's best interests.

The fund's board created the committee in May to consider the charges raised in the complaint and to review the facts underlying the allegations. After reviewing numerous documents and interviewing 11 witnesses over approximately a six-month period, the committee determined that there was no evidence to support plaintiff's allegations, and that dismissal of the action would best serve the interests of the fund and its shareholders. Concurring in this view, the court found that the defendants met their burden of showing that:

- the committee was independent;
- the investigation was conducted in good faith; and
- the committee had a reasonable basis for its decision.

In addition, the court found no basis on the grounds of business judgment to permit this action to go forward. The court noted that the committee's mandate was not to judge the performance of the rights offering in hindsight, but rather to assess whether, at the time it was conceived and implemented, the defendants "made an informed and reasonable market forecast based on diligent investigation that reasonably appeared to further the shareholders' best interest." The court concluded that the findings and conclusions of the committee had been made independently, reasonably and in good faith, and, that the stockholder grievance did not merit further consideration in the corporation's interest. *Strougo v. Bassini*, S.D.N.Y., 99 Civ. 3579 (RWS), (September 8, 2000).

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