

Investment Services Regulatory Update

June 1, 2009

LITIGATION

Eighth Circuit Adopts a New Standard for Evaluating Mutual Fund Excessive Fee Claims

On April 8, 2009, in *Gallus v. Ameriprise Financial, Inc.*, the U.S. Court of Appeals for the Eighth Circuit weighed in on the ongoing debate regarding the evaluation of advisory fees and the corresponding fiduciary duty set forth in Section 36(b) of the 1940 Act and, in doing so, added yet another wrinkle to a debate which has worked its way up to the U.S. Supreme Court.

Much like *Jones v. Harris Associates*, for which the Supreme Court granted *certiorari* in March 2009, the dispute in *Gallus* arose out of the plaintiffs' allegation that the advisory fees paid to the investment adviser by a group of mutual funds managed and distributed by Ameriprise Financial Inc. and its affiliates were excessive and constituted a breach of Ameriprise's fiduciary duty as set forth in Section 36(b) of the 1940 Act. However, in contrast to *Jones*, the plaintiffs in *Gallus* also alleged that Ameriprise breached its fiduciary duty by misleading the Board, thereby tainting the advisory fee review process. Based on a traditional analysis under *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, the district court found that the advisory fees paid to Ameriprise did not run afoul of Section 36(b) of the 1940 Act, and thus granted summary judgment in favor of Ameriprise. The Eighth Circuit reversed the lower court's grant of summary judgment and remanded the case to the district court for further proceedings. In doing so, the Eighth Circuit articulated a new standard for the review of excessive fee cases arising under Section 36(b) of the 1940 Act. The Eighth Circuit adopted portions of and diverged from both the Second Circuit's standard as set forth in *Gartenberg* and the Seventh Circuit's standard articulated in *Jones*.

In partially adopting the *Gartenberg* standard, the Eighth Circuit concluded that "the *Gartenberg* factors provide a useful framework for resolving claims of excessive fees...." However, the Eighth Circuit went on to state that the *Jones* case highlights a flaw in the way many courts have applied *Gartenberg*, and noted that the size of the advisory fee is one factor to consider in evaluating claims arising under Section 36(b) of the 1940 Act. According to the Eighth Circuit, "the *Gartenberg* case demonstrates one way in which a fund adviser can breach its fiduciary duty; but it is not the only way.... [T]he [*Gartenberg* standard] should not be construed to create a safe harbor of exorbitance, for under such a view an adviser's fiduciary duty would be diluted to a simple and easily satisfiable requirement not to charge a fee that is egregiously out of line with industry norms."

The Eighth Circuit also took issue with the *Jones* approach in that it does not allow for the comparison between the fees an investment adviser charges its captive funds and the fees it charges its institutional clients, but adopted the *Jones* approach to the extent it imposes upon investment advisers a "duty to be honest and transparent throughout the negotiation process" in relation to the approval of advisory fees.

According to the Eighth Circuit, with respect to claims arising under Section 36(b) of the 1940 Act, a court's review should include the evaluation of an investment adviser's conduct throughout the negotiation process relating to the approval of advisory fees and the end result of such negotiation. "Unscrupulous behavior with respect to either can constitute a breach of fiduciary duty." Furthermore, the Eighth Circuit noted there was a particularly strong argument in the *Gallus* case for comparing the fees Ameriprise charged its mutual fund clients to those it charged its institutional clients because the investment advice may have been essentially the same for both clients.

In shaping its new, hybrid, Section 36(b) standard of review, the Eighth Circuit reaffirmed the notion that "Section 36(b) does not allow a court 'to substitute its business judgment for that of a mutual fund's board of directors in the areas of management fees' [and, furthermore, that] candid, transparent negotiation does not require discussion of every issue that a plaintiff might find relevant; and it does not require the adoption of a particular negotiation strategy." Despite the plaintiffs' contention, the Eighth Circuit was also careful to observe that a fee negotiation's focus on advisory fees charged throughout the industry is not a *per se* breach of fiduciary duty. "[W]hile tethering fees to an industry median will not provide sure-fire protection from Section 36(b) liability, [neither is it] necessarily suspect." In fact, "it is common business strategy to attempt to meet or surpass the value offered by one's primary competitors ... and there is no reason to assume it indicates bad faith."

Prospectively, it is hard to assess the impact of the *Gallus* decision, as any standard articulated by the Supreme Court would trump the diverging standards of review under Section 36(b). That said, the *Gallus* standard, to the extent it is applied, may render it more difficult for a defendant to secure dismissal on the pleadings in cases arising under Section 36(b), as plaintiffs will seek to discover more extensive materials concerning the fee review process and will seek to exploit any apparent contradiction or variation therein. It also bears mentioning that, assuming *certiorari* is sought in *Gallus*, it is quite possible the Supreme Court will hear the case because of its substantial overlap with *Jones*.

U.S. Supreme Court Agrees to Hear *Jones v. Harris Associates*

On March 9, 2009, the U.S. Supreme Court granted certiorari in *Jones v. Harris Associates*, in which the Seventh Circuit explicitly rejected the *Gartenberg* standard (from the Second Circuit) for evaluating advisory fees and adopted a new standard, which looks to market efficiency and trust law fiduciary duty rather than "reasonableness."

The Supreme Court will hear the case in its October 2009 term and will likely resolve the Circuit split concerning the appropriate standard for reviewing excessive fee claims arising under Section 36(b) of the 1940 Act.

NEW RULES AND GUIDANCE

SEC Proposes Amendments to Proxy Rules to Facilitate Rights of Shareholders to Nominate Directors

On May 20, 2009, the SEC voted to propose amendments to the proxy rules to enhance the rights of shareholders to nominate directors for corporate boards, including boards of investment companies. Under the proposed amendments, Rule 14a-11 under the Exchange Act would be created to allow eligible shareholders to have their nominees included in a company's proxy materials. In addition, the proposed amendments would modify Rule 14a-8 under the Exchange Act to allow eligible shareholders to include proposals in a company's proxy materials that would amend provisions of a company's governing documents concerning the company's director nomination procedures or other director nomination disclosure provisions. A shareholder submitting a proposal under modified Rule 14a-8 would be subject to the current eligibility requirements of the Rule.

Under proposed Rule 14a-11, a shareholder would be eligible to have their nominee included in a fund's proxy materials if the shareholder owns: (i) at least 1% of the voting securities of a fund with net assets of \$700 million or more; (ii) at least 3% of the voting securities of a fund with net assets between \$75 million and \$700 million; or (iii) at least 5% of the voting securities of a fund with net assets of \$75 million or less. Shareholders would be allowed to aggregate holdings to meet these ownership thresholds. In addition to the ownership requirements, under proposed Rule 14a-11, a shareholder would also have to: (i) have held their shares for at least one year; (ii) sign a statement declaring their intent to continue to hold their shares through the annual meeting at which directors are elected; and (iii) certify that they are not holding their shares for the purpose of gaining control of the company or to gain more than a minority representation on the board of directors. An eligible shareholder would only be allowed to have one nominee or a number of nominees that would represent up to 25% of a company's board of directors included in the company's proxy materials. A nominating shareholder would be required to file a new Schedule 14N with the SEC that would include the information and certifications required under proposed Rule 14a-11. A company would not be liable for any false or misleading statements in information provided by the nominating shareholder unless the company knows or has reason to know the information is false or misleading.

Comments on the proposals will be due 60 days after publication in the Federal Register.

SEC Proposes Amendments to Investment Adviser Custody Rule

On May 14, 2009, the SEC proposed amendments to Rule 206(4)-2 under the Advisers Act, which regulates the custody practices of registered investment advisers. The SEC also proposed related amendments to Form ADV and Form ADV-E. The amendments are intended to improve the safekeeping of client assets when an adviser has custody of client funds and/or securities. The SEC is proposing to amend Rule 206(4)-2 to:



- Require that all advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets. (Under the current Rule, a surprise examination is not required for accounts for which the adviser has a reasonable belief that a qualified custodian provides account statements directly to the client.)
- Require advisers with custody of client assets to enter into a written agreement with an independent public accountant that, among other things, obligates the accountant to: (i) conduct a surprise examination; (ii) notify the SEC within one business day of finding a material discrepancy; (iii) submit Form ADV-E to the SEC within 120 days of the time chosen for the surprise examination; and (iv) submit Form ADV-E to the SEC within four business days of the accountant's resignation from or termination of the engagement.
- Make privately offered securities (as defined in the Rule) that advisers hold on behalf of their clients subject to the surprise examination. (Privately offered securities are not currently subject to any part of the Rule.)
- Provide that an adviser is deemed to have custody of any client securities or funds that are directly or indirectly held by a related person of the adviser (i.e., a person directly or indirectly controlling or controlled by the adviser or any person under common control with the adviser) in connection with advisory services provided by the adviser to its clients.
- Require that when an adviser or a related person serves as a qualified custodian for client assets, the adviser must obtain, or receive from the related person, an annual written internal control report from an independent public accountant registered with the Public Company Accounting Oversight Board regarding the adviser's or the related person's controls relating to custody of client assets, which includes an opinion of the accountant regarding the custody controls in place and tests of their effectiveness (e.g., a Type II SAS 70 Report).
- Require that when an adviser or a related person serves as a qualified custodian for client assets, the annual surprise examination must be performed by an independent public accountant registered with the PCAOB.
- Require advisers with custody of client assets to have a reasonable belief based on due inquiry that the qualified custodian sends an account statement, at least quarterly, to each client for which the qualified custodian maintains assets.

- Require advisers to include a statement in the notice sent to clients upon opening a custodial account on their behalf that the client should compare the account statements they receive from the custodian with those they receive from the adviser.

Comments on the proposals are due by July 28, 2009.

Implementation of Identity Theft Prevention Programs Delayed Until August 1, 2009

On April 30, 2009, the Federal Trade Commission announced that it would suspend enforcement of the red flags rule under the Fair and Accurate Credit Transactions Act of 2003, which impose identity theft-related requirements on “financial institutions” and other specified entities, until August 1, 2009.

Under the red flags rule, a “financial institution” includes any institution, including an investment company, that directly or indirectly holds a transaction account belonging to a consumer, and a “transaction account” is an account in which the account holder is permitted to make withdrawals payable to third persons by check, transferable or negotiable instruments or similar items (e.g., debit cards).

The rule requires funds that hold transaction accounts to develop and obtain board approval of a written Identity Theft Prevention Program by August 1, 2009. The Program must be designed to detect, prevent and mitigate identity theft in connection with covered accounts. The Program must be able to detect patterns, practices and certain “red flag” activities that potentially signify identity theft. Specifically, the Program must include “reasonable policies and procedures” to: (1) identify red flag activities for covered accounts and incorporate any newly identified red flag activities into the Program; (2) detect red flag activities; (3) respond to red flag activities that have been detected; and (4) update the Program periodically to reflect changes in risks. For each of these items, the rule requires the financial institution to consider specific guidelines and include in its Program those guidelines that are appropriate given the size and complexity of the institution and the nature and scope of its activities.

The new rule also imposes certain requirements related to the administration of the Program, including: (1) obtaining approval of the Program by the institution’s board or a committee thereof, (2) involving the board, committee or designated senior management person in the oversight, development, implementation and administration of the Program, (3) training staff to effectively implement the Program, and (4) exercising appropriate and effective oversight of service provider arrangements.



MONEY MARKET FUND NEWS

U.S. Treasury Extends Temporary Guarantee Program for Money Market Funds

On March 31, 2009, the Treasury announced another extension of its Temporary Guarantee Program for Money Market Funds until September 18, 2009 to support ongoing stability in the market. Only money market funds that initially participated in the Program and meet the extension conditions and procedural requirements are eligible to continue to participate in the Program. The conditions for a fund's continued participation in the Program include: (1) no "guarantee event" (i.e., the fund has not "broken the buck" and liquidated) has occurred on or before May 1, 2009, (2) the market-based NAV of the fund on May 1, 2009 is at least \$0.995, and (3) the fund's board, including a majority of the independent directors, determines that the fund's continued participation in the Program is in the best interests of the fund and its shareholders. The procedural requirements include making an extension payment and submitting an extension notice by April 13, 2009 and a bring-down notice by May 11, 2009. Similar to the prior payments, this extension payment is based on a fund's NAV as of September 19, 2008. The extension payments are similar to the prior extension payments; the extension payments are 1.5 or 2.3 basis points compared to the 1.5 or 2.25 basis point initial extension payment. The Program as extended would continue to only provide coverage to shareholders on September 19, 2008.

In order to participate in the Program, a fund had to enter into a Guarantee Agreement with the Treasury. Under the Guarantee Agreement, the Treasury will make a guarantee payment to a fund for its covered shareholders if: (i) the fund's market-based NAV drops below \$0.995 prior to September 18, 2009 (if the fund participates in extension of the Program); (ii) the fund reports this occurrence to the Treasury by the next business day; and (iii) the fund's board begins the process of liquidating the fund within five business days of the fund's market-based NAV dropping below \$0.995. Any guarantee payments made by the Treasury under the Program cannot exceed the amount of the Exchange Stabilization Fund (the "ESF"), which is the funding vehicle for the Program. The ESF currently has approximately \$50 billion in assets. The amount available under the ESF will be reduced by the amounts paid to each fund that breaks the buck and requests a guarantee payment pursuant to the Program. If a fund breaks the buck and requests a guarantee payment on the same day as other money market funds and the amount available in the ESF is not sufficient to meet all requested payments, then the funds will only receive a pro rata share of the available ESF amount. Additionally, under the Guarantee Agreement, the Treasury reserves the right to use the amounts available in the ESF, including funds held by the ESF that have been designated for use in the Program, for any other purpose. According to the Treasury, as of March 31, 2009, the Program covers over \$3 trillion of combined fund assets.

ICI Money Market Working Group Issues Report

On March 17, 2009, the ICI's Money Market Working Group, a group formed to develop recommendations to improve the functioning of the money market and the operation and

regulation of money market funds, issued a report making recommendations that generally would:

- Impose daily and weekly minimum liquidity requirements (including a daily requirement for taxable money market funds of 5% of net assets in securities accessible within one day and a weekly requirement for all money market funds of 20% of net assets in securities accessible within seven days) and require regular stress testing of a money market fund's portfolio.
- Tighten the portfolio maturity limit currently applicable to money market funds from 90 to 75 days and add a new portfolio maturity limit calculation methodology.
- Raise the credit quality standards under which money market funds operate by requiring money market funds to establish a "new products" or similar committee, maintaining ratings in Rule 2a-7 as a starting point for credit analysis and requiring that money market funds designate at least three rating agencies to monitor for credit analysis purposes.
- Address "client risk" by requiring money market fund advisers to adopt "know your client" procedures and requiring money market funds to disclose client concentrations by type of client and the potential risks, if any, posed by a fund with a client base that is strongly concentrated.
- Enhance risk disclosure for investors and the market and require monthly website disclosure of a money market fund's portfolio holdings.
- Assure that when a money market fund proves unable to maintain a stable \$1.00 NAV, all of its shareholders are treated fairly.
- Enhance government oversight of the money market by developing a non-public reporting regime for all institutional investors in the money market, including money market funds, and encouraging the SEC staff to monitor higher-than-peer performance of money market funds.
- Address market confusion about cash management investment vehicles that appear to be—but are not—money market funds.
- Permit money market fund boards to suspend redemptions under certain circumstances.
- No longer permit money market funds to invest in "second tier securities."
- Modernize money market fund regulation to reflect the appropriate oversight role for fund boards.

The Working Group's recommendations seek to (1) respond directly to potential weaknesses in money market fund regulation; (2) identify potential areas for reform that are consistent with improving the safety and oversight of money market funds; and (3) provide the government detailed data to allow it to better discern trends and the role played by all institutional investors, including money market funds, in the overall money market, and invite greater surveillance of outlier performance of money market funds that may indicate riskier strategies.

The ICI's Board has endorsed the Working Group's recommendations and urges all money market fund members to voluntarily implement those recommendations that do not require prior regulatory action by September 18, 2009. According to the ICI, the fund families represented on the Working Group have acknowledged that they are ready to do so.

OTHER NEWS

Mutual Fund Directors Forum Issues Guidance for Directors on the Oversight of Sub-Advisers

In April 2009, the Mutual Fund Directors Forum issued a report entitled "Practical Guidance for Directors on the Oversight of Sub-Advisers," which provides an overview of issues fund directors should consider when selecting and supervising sub-advisers. The report provides statistics on fund use of sub-advisers and notes reasons advisers and fund boards turn to sub-advisers and the unique board oversight challenges posed. The report issued the following guidance for fund directors:

- Directors should understand the reasons why a fund's adviser recommends the use of a sub-adviser and the adviser's search and selection process used to identify sub-advisers.
- Directors should assure themselves that the adviser has adequate resources to monitor the sub-advisory relationship.
- Directors should understand the capabilities and expertise of the sub-adviser.
- Directors should obtain information on the organization and compliance program of the sub-adviser before entering into a sub-advisory contract.
- Directors should understand why a new sub-adviser is preferable to the existing sub-adviser.
- Lack of access to complete information may make measuring profitability on the sub-advisory contract difficult.

- Directors should take special care when reviewing contracts when multiple sub-advisers manage a single fund.
- Affiliated sub-advisers require additional attention by the board.
- Directors need to exercise care to maintain their independence of the sub-adviser.
- The board should understand the fund chief compliance officer's capabilities in overseeing activities of the sub-advisers.
- The board should determine how best to communicate with the sub-adviser.
- The fund's chief compliance officer should review a sub-adviser's soft dollar procedures.
- The board may wish to monitor a sub-adviser's trade allocation practices.
- The board should understand how a sub-adviser monitors risks associated with the use of complex instruments.
- The board should review the sub-adviser's proxy voting policies to ensure they are compatible with the fund's proxy voting policies.
- The adviser and sub-adviser may work together to provide consistent valuations for securities across the complex.
- The board should understand the necessary steps when a sub-advisory relationship is terminated.

SEC Staff Speech on Investment Companies' Use of Derivatives

On April 17, 2009, the Director of the SEC's Division of Investment Management, Andrew ("Buddy") Donohue, gave a speech outlining his concerns over the use of derivatives by investment companies. In his speech, Mr. Donohue described the 1940 Act's limitations on leverage, the concept of senior securities, and the SEC's and staff's interpretations of Section 18, including a 30-year old Release that is the SEC's starting point on addressing fund leverage. In his discussion of Release No. 10666, Mr. Donohue stated that the SEC cautioned directors to consider the "potential loss of flexibility" when determining the extent to which funds engage in leveraged transactions. Furthermore, he noted that the SEC suggested that directors review a fund's disclosure documents to "ensure complete disclosure," including: (1) the potential risk of loss; (2) the identification of the securities trading practices as separate and distinct from the underlying securities; (3) the differing investment goals inherent in participating in the securities trading practices versus investing in the underlying securities; (4) whether the

fund's name accurately reflects its portfolio investment policies and securities trading practices; and (5) any other material information relating to such trading practices.

Next, Mr. Donohue discussed the current state of derivatives risk disclosure. He noted that "extensive risk disclosure, however, may not equal a discussion readily understandable by investors." He also cited an SEC concept release which stated that "lengthy and highly technical descriptions of permissible policies and investments that are often used in meeting existing requirements may make it difficult for investors to understand the total risk level of a fund." Mr. Donohue made it clear that he was not stating that fund disclosures were legally deficient. Instead, he suggested that investors, particularly retail investors, may not have "appreciated the potential magnitude of" the impact that derivatives may have on fund portfolios that employ leveraged strategies during the recent market downturn, nor "anticipated the actual diminution in value of" those funds as a result of leverage.

Finally, Mr. Donohue noted three broad concerns regarding funds' use of derivatives: (1) funds should have a means to deal effectively with derivatives outside of disclosures; (2) funds should address both implicit and explicit leverage; and (3) funds should address diversification from investment exposures taken on versus the amount of money invested.

FASB Issues Staff Positions on Fair Value Measurements and Impairments of Securities

On April 9, 2009, the Financial Accounting Standards Board posted Staff Positions regarding fair value measurements and impairment of securities. The first FASB Staff Position, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That are Not Orderly* (FAS 157-4), provides additional guidance for estimating fair value when the volume and level of activity for an asset has significantly decreased. FAS 157-4 emphasizes that even in these situations, and regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same (i.e., the price that would be received to sell an asset in an orderly transaction—not a forced or distressed sale—between market participants at the measurement date under current market conditions). FAS 157-4 also includes guidance on identifying circumstances that indicate a transaction is not orderly.

The second FASB Staff Position, *Recognition and Presentation of Other-Than-Temporary Impairments* (FAS 115-2 and FAS 124-2), provides additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on debt securities. The FSP is intended to provide greater clarity to investors about the credit and non-credit component of an other-than-temporary impairment event and more effectively communicate when an other-than-temporary impairment has occurred.

The FSPs are effective for interim and annual periods ending after June 15, 2009, and must be applied prospectively. Early adoption is permitted only for periods ending after

March 15, 2009 and if one FSP is early adopted, the other FSP must be early adopted. In the period of adoption, a reporting entity must disclose any changes resulting from the application of the FSPs.

SEC Issues Additional Guidance Relating to Liquidity Protected Preferred Shares

On March 12, 2009, the staff of the SEC's Division of Investment Management issued a no-action letter stating that it would not recommend enforcement action in connection with certain transactions involving liquidity protected preferred shares ("LPPS") issued by closed-end funds. While a previous no-action letter issued by the staff in 2008 addressed LPPS, it did not address whether a liquidity provider for LPPS, or an affiliate of the liquidity provider, would be deemed to control or otherwise be an affiliate of a fund solely as a result of the liquidity provider purchasing LPPS. The ICI noted that a liquidity provider's acquisition of a large portion of a fund's LPPS may raise certain affiliation issues under the 1940 Act and thereby limit the liquidity provider's business dealings with a fund. The staff agreed, based on the facts, representations and assumptions set forth by the ICI in its request, not to recommend enforcement action against a liquidity provider or a fund, with respect to the liquidity provider, under the provisions of the 1940 Act and the rules thereunder applicable to affiliated persons of a fund or affiliated persons of affiliated persons of a fund that would be triggered solely by the liquidity provider's acquisition of the LPPS of a fund or by the liquidity provider's contractual right to sell to the fund, or an affiliate of the fund, such acquired LPPS.

ICI Issues White Paper on Financial Services Regulatory Reform

On March 3, 2009, the ICI issued a white paper, "Financial Services Regulatory Reform: Discussion and Recommendations," outlining its recommendations for how to modernize and strengthen regulatory oversight of the U.S. financial services industry.

The ICI supports the designation of a new or existing agency or inter-agency body as a "Systemic Risk Regulator." The ICI suggests that the Systemic Risk Regulator should have responsibility for: (1) monitoring the financial markets broadly; (2) analyzing changing conditions in domestic and overseas market; (3) evaluating the risks of practices as they evolve, and identifying those that are of such nature and extent that they implicate the health of the financial system at large; and (4) acting to mitigate such risks in coordination with other responsible regulators.

The ICI recommends changes to create a regulatory framework that enhances regulatory efficiency, limits duplication, closes regulatory gaps and emphasizes the national character of the financial services industry. The ICI envisions a new "Capital Markets Regulator," which would encompass the combined functions of the SEC and the CFTC and create a single independent federal regulator responsible for oversight of U.S. capital markets, market participants and all financial investment products. The ICI further recommends that Congress consider consolidating the regulatory structure for the banking sector and authorize an optional federal charter for insurance companies.

The ICI states that such new Capital Markets Regulator would be the regulatory standard setter for all registered investment companies, including money market funds. Furthermore, the ICI suggests that the Capital Markets Regulator should be granted explicit authority to regulate in certain areas where there are currently gaps in regulation—in particular, hedge funds, derivatives and municipal securities—and explicit authority to harmonize the legal standards applicable to investment advisers and broker-dealers.

ENFORCEMENT ACTIONS

SEC Settles Enforcement Action Against NYLIM Relating to Disclosures to Fund Board During 15(c) Process

On May 8, 2009, the SEC settled an administrative enforcement action against New York Life Investment Management LLC (“NYLIM”) regarding NYLIM’s disclosures to a fund board during three annual investment advisory contract renewal process periods and certain disclosures about the cost to shareholders of a guarantee feature applicable to their investment in the MainStay Equity Index Fund. The Fund is an S&P 500 index fund that offered investors an unconditional guarantee from NYLIM’s affiliate, NYLIFE LLC.

The SEC found that, as part of the 15(c) process in 2002 and 2003, NYLIM had urged the Fund’s board to consider the guarantee feature in evaluating NYLIM’s management fee, which was the highest in a peer group of funds, but failed to provide the board with information reasonably necessary to evaluate the cost of the guarantee. In January 2002, NYLIFE LLC set up a reserve on its books with respect to the estimated expenses of the guarantee due to deteriorating market conditions. The reserve expense was included in the profitability data NYLIM provided to the board. The SEC found that NYLIM had failed to provide the board with information allowing the board to appropriately consider the reserve that NYLIFE LLC had established on its books, or to explain to the board why NYLIM believed NYLIFE LLC’s reserve should be reflected in the adviser’s analysis of profitability for purposes of the 15(c) process. As a result of this alleged conduct, the SEC found that NYLIM willfully violated Section 15(c) of the 1940 Act.

The SEC also found that from early 2002 through June 30, 2004, at the same time NYLIM was claiming that the guarantee should be considered to justify NYLIM’s management fee, NYLIM filed prospectuses and annual reports in which it represented that there was no charge to the Fund or its shareholders for the guarantee. As a result of this alleged conduct, the SEC found that NYLIM willfully violated Section 34(b) of the 1940 Act, concluding that these statements were false or misleading as evidenced by NYLIM’s representations during the 15(c) process that its higher management fee was justified by the guarantee. In June 2004, NYLIM revised the fund’s prospectus disclosure to note that there was not a separate expense for the guarantee, but that the guarantee was considered in connection with setting the management fee.

As a result of the settlement, NYLIM was ordered to cease and desist from violations of the Advisers Act and the 1940 Act, was censured and was ordered to pay disgorgement of \$3,950,075 (the amount NYLIM received in management fees from the Fund, from March 12, 2002 through June 30, 2004, in excess of the peer median), prejudgment interest of \$1,350,709 and a civil penalty of \$800,000, for a total payment of \$6,100,784.

FINRA Settles Auction Rate Securities Violations with Four Firms

On May 7, 2009, the Financial Industry Regulatory Authority announced that it had entered into final agreements with NatCity Investments, Inc., M&T Securities, Inc., Janney Montgomery Scott LLC and M&I Financial Advisors, Inc., to settle charges relating to the sale of Auction Rate Securities ("ARS"). Each of the four firms agreed to initiate or complete offers to repurchase ARS sold to their customers in connection with failed ARS auctions.

According to FINRA, its investigation of the firms uncovered evidence that each firm employed the use of unfair and unbalanced advertising, marketing materials or other internal communications in its efforts to sell ARS, and did not adequately disclose to customers the potential for ARS auctions to fail and the consequences of such failures. Moreover, FINRA's investigation of the firms revealed that each firm failed to maintain adequate supervisory systems reasonably designed to achieve compliance with the securities laws and FINRA rules with respect to the marketing and sale of ARS.

Under the terms of the agreements, each firm will offer to repurchase at par value certain outstanding ARS purchased by investors between May 31, 2006, and February 28, 2008. As a result, a total of approximately \$554 million of ARS are eligible for repurchase. Additionally, the firms have agreed to compensate individual investors who sold ARS below par after February 28, 2008 and pay fines totaling \$850,000. Going forward, any additional claims against the firms for consequential damages resulting from investors' inability to access funds invested in ARS will be resolved by an independent, non-industry arbitrator.

To date, FINRA has settled claims relating to alleged auction rate securities violations with a total of nine firms, imposing a total of \$2.6 million in fines and guaranteeing the return of over \$1 billion to investors.

SEC Charges Operators of Reserve Primary Fund With Fraud

On May 5, 2009, the SEC charged several entities and individuals who operate the Reserve Primary Fund for failing to provide key material facts to investors and trustees about the fund's vulnerability as Lehman Brothers sought bankruptcy protection. The SEC is also seeking to expedite the distribution of the fund's remaining assets to investors.

The SEC alleged that the investment adviser to the Reserve Primary Fund, Reserve Management Company, Inc. ("RMCI"), its Chairman Bruce Bent Sr., its Vice Chairman

and President, Bruce Bent II, and the Fund's distributor, Resrv Partners, Inc., failed to provide key material information to investors, the Fund's board of trustees and rating agencies. According to the complaint, the defendants misrepresented that RMCI would provide credit support necessary to protect the \$1 net asset value of the Fund when, in fact, RMCI had no such intention. The SEC also alleged that RMCI significantly understated the volume of redemption requests received by the Fund and failed to provide the trustees with accurate information concerning the value of Lehman Brothers' securities. As a result of such alleged misrepresentations and omissions, the Fund was unable to strike a meaningful hourly net asset value as required by the Fund's prospectus.

FINRA Fines 25 Firms More Than \$2.1 Million for Failures in Mutual Fund Breakpoint Review

On March 23, 2009, FINRA announced that it fined 25 broker-dealers a total of \$2,145,000 for failures related to their completion of FINRA's firm self-assessment of mutual fund breakpoint discount compliance, which required firms that sold front-end load mutual funds to review their compliance in providing breakpoint discounts to customers during 2001 and 2002 and report those results to FINRA.

The alleged violations include failure to: accurately report information; send timely notices and responses to customers concerning the availability of breakpoint discounts; provide timely refunds for missed breakpoints to customers; and correctly calculate such refunds.

SEC Charges Madoff Auditors With Fraud

On March 18, 2009, the SEC charged the auditors of Bernard Madoff's broker-dealer firm with committing securities fraud by misrepresenting that they had conducted legitimate audits. From 1991 through 2008, David G. Friehling and his firm, Friehling & Horowitz, CPAs, P.C., purported to audit financial statements and disclosures of Bernard L. Madoff Investment Securities LLC. As a result of such services, F&H provided its opinion in Madoff's annual audit report that Madoff's financial statements were prepared pursuant to Generally Accepted Auditing Standards, including the requirement to perform audit procedures regarding custody of securities. In addition, F&H also made representations that Madoff's financial statements were presented in conformity with Generally Accepted Accounting Principles and that Mr. Friehling reviewed internal controls at Madoff's firm, including controls over the custody of assets, and found no material inadequacies.

The SEC's complaint alleges that such statements were materially false because Mr. Friehling and F&H did not perform a meaningful audit of Madoff's firm and did not perform procedures to confirm that customers' securities existed. Instead, the SEC alleges that Mr. Friehling pretended to conduct minimal audit procedures of certain accounts to make it appear that he was conducting an audit, and then failed to document his purported findings and conclusions as required under GAAS. If properly stated, the

financial statements, along with Madoff's related disclosures regarding reserve requirements, would have shown that Madoff's firm was insolvent and owing tens of billions of dollars in additional liabilities to its customers. The SEC's complaint seeks, among other items, financial penalties and a court order requiring both Mr. Friebling and F&H to disgorge their ill-gotten gains. The SEC's investigation is continuing.

SEC Charges Investment Adviser For Inventing a Billion-Dollar Client to Lure New Investors

On March 9, 2009, the SEC charged a money manager with offices in New York and Rhode Island for misrepresenting the existence of a billion-dollar client in order to gain credibility and attract legitimate investors. The SEC charged Leila Jenkins and her firm, Locke Capital Management Inc., with inventing the client and repeatedly lying about its existence in order to attract other clients. In addition, the SEC alleged that Ms. Jenkins lied to the SEC staff about the existence of the purported client and furnished the SEC staff with falsified documents in 2008, including fake account statements. According to the SEC, from at least 2003 to 2009, misstatements concerning accounts were communicated in brochures, meetings, submissions to online databases that prospective clients used to select money managers, and in SEC filings.

Ms. Jenkins was charged with additional violations including advertising performance for years in which Ms. Jenkins had no clients and misrepresentations regarding the makeup of the firm, including the number, identity and role of its employees. The SEC is seeking a monetary penalty, disgorgement of ill-gotten gains, and a permanent injunction against future violations of the antifraud and other provisions of the securities laws. The SEC's investigation is continuing.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.

