Investment Services Regulatory Update

July 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*.

NEW RULES AND GUIDANCE

SEC Proposes Rule Amendments to Strengthen the Regulatory Framework for Money Market Funds

On June 24, 2009, the SEC proposed amendments to certain rules under the 1940 Act that govern money market funds. The proposed rule amendments seek to: (1) increase the resilience of money market funds to short-term market risks, (2) reduce the likelihood of money market funds "breaking the buck," and (3) improve the ability of the SEC to oversee money market funds. As proposed, the rule amendments would:

- prohibit money market funds from investing in "second tier securities,"
- impose a 60-day weighted average maturity limit,

- impose a new maturity test that would limit "weighted average life maturity" (the measurement of a money market fund's portfolio maturity without regard to any interest reset dates) to 120 days,

- prohibit money market funds from acquiring illiquid securities,

- require money market funds to hold at all times highly liquid securities sufficient to meet reasonably foreseeable redemptions,

- require *taxable* retail funds to invest at least 5% of assets and *taxable* institutional funds to invest at least 10% of assets in "daily liquid assets" (cash, direct obligations of the U.S. Government and securities that will mature or are subject to a demand feature that is exercisable and payable within one business day),

- require all money market funds (including tax-exempt funds) to maintain weekly liquidity requirements of (1) 15% of assets in "weekly liquid assets" (cash, direct obligations of the U.S. Government and securities that will mature or are subject to a demand feature that is exercisable and payable within five business days) for retail funds and (2) 30% of assets in "weekly liquid assets" for institutional funds,

- require boards of money market funds to determine at least once each calendar year whether a fund is an institutional money market fund for purposes of meeting the daily and weekly liquidity requirements based on (1) the nature of the record owners of fund shares, (2) minimum amounts required to establish an account, and (3) historical cash flows, resulting or expected cash flows that would result, from purchases and redemptions,

- require boards of money market funds to adopt procedures providing for periodic stress testing of a fund's portfolio, including testing of a fund's ability to maintain a stable net asset value per share based on certain hypothetical events set forth in the proposed amendments,

- limit money market funds to investing in repurchase agreements collateralized by cash or U.S. Government securities in order to obtain special treatment under the diversification provisions of Rule 2a-7,

- require boards of money market funds or their delegates to evaluate the creditworthiness of a counterparty to a repurchase agreement, whether or not the repurchase agreement is collateralized fully,

- require money market funds to post their portfolio holdings as of each month end to their website no later than the second business day after month end and to maintain such information on the website for at least 12 months,

- require money market funds to file a monthly portfolio holdings report with the SEC on new Form N-MFP no later than the second business day after month end to provide more detailed portfolio holdings information to the SEC than that posted on a fund's website,

- require boards of money market funds to determine at least once each calendar year that a fund has the capacity to redeem and sell fund shares at prices based on the current net asset value per share, including the market based net asset value per share,

- expand Rule 17a-9 to allow an affiliate to purchase a portfolio security from a money market fund (1) if the security has defaulted (other than an immaterial default unrelated to the financial condition of the issuer) even though the security remained an eligible security or (2) for any reason if the security is purchased with cash at the greater of amortized cost value or market value and the affiliate promptly remits to the fund any profit it realizes from a later sale of the security,

- require a money market fund whose securities have been purchased by an affiliate in reliance on Rule 17a-9 to provide the SEC via e-mail with prompt notice of the purchase and the reasons for the purchase, and

- create new Rule 22c-3, which would permit money market funds to suspend redemptions upon breaking the buck if a fund's board, including a majority of independent directors, approves the liquidation of the fund in order to facilitate an orderly liquidation of the fund.

In the proposing release, the SEC also requested comment on additional amendments that the SEC considered but did not propose and on more far-reaching changes to the regulatory and business model of money market funds. Specifically, the SEC requested comment on:

- the elimination of a money market fund's ability to use the amortized cost method of valuation,

- whether money market funds should be required to satisfy redemption requests in excess of a certain size through in-kind redemptions,

- a proposal that would require boards of money market funds to annually designate three nationally recognized statistical rating organizations that a fund would look to for all purposes under Rule 2a-7 in determining whether a security is an eligible security,

- whether Rule 2a-7 should be amended to address risks presented by structured investment vehicles or similar asset-backed securities,

- whether the diversification requirements of Rule 2a-7 should be amended in any way, and
- whether money market funds should be permitted to temporarily suspend redemptions at certain other times apart from liquidation of a fund.

Comments on the proposal are due by September 8, 2009.

FinCEN Issues Proposal to Define Mutual Funds as "Financial Institutions"

On June 5, 2009, FinCEN issued a proposal that would include mutual funds within the general definition of "financial institution" in rules implementing the Bank Secrecy Act. The proposal would replace an existing anti-money laundering requirement for mutual funds to report transactions over $10,000 that involve currency (cash and coins), cashier checks, money orders, bank drafts or travelers checks on Form 8300 with the requirement to file Currency Transaction Reports for currency transactions over $10,000, which is the standard for other financial institutions. Because most mutual funds do not accept cash or coins, the proposal practically would eliminate any reporting requirements for mutual funds. However, the proposal would not relieve mutual funds of their responsibility to file suspicious activity reports for clients suspected of money laundering and/or the financing of terrorism.

The proposal also would subject mutual funds to the "Travel Rule," which requires the creation and retention of records for transmittals of funds and the transmittal of information on these transactions to other financial institutions in the payment chain. However, since mutual funds would be excepted from most of the Travel Rule's requirements, the effect of the proposal would be to require mutual funds to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities and credit for transactions exceeding $10,000.

Comments on the proposal are due by September 3, 2009.

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

On May 20, 2009, the SEC proposed 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. A shareholder would have to meet all the requirements of Rule 14a-11 to have their nominee included in a company's proxy materials and Rule 14a-11 would not be available if the company's governing documents prohibited shareholders from nominating candidates to the board. 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. For purposes of Rule 14a-11, generally a fund's net assets would be the net assets disclosed in a fund's semi-annual report on Form N-CSR filed in the fiscal year immediately preceding the meeting date. However, the net assets for a fund with multiple series would be determined as of June 30th of the calendar year immediately preceding the meeting date and the fund would be required to file a Form 8-K disclosing its net assets as determined above within four business days of setting a meeting date. 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 are due by August 17, 2009.

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 require 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.

OTHER NEWS

SEC Staff Issues No-Action Letter on TALF Loans for Registered Funds

On June 19, 2009, the Staff of the SEC responded to a letter from Franklin Templeton Investments requesting no-action assurances relating to mutual fund or closed-end fund participation in the Term Asset-Backed Securities Loan Facility ("TALF"), which involves non-recourse loans that are collateralized by investments in certain eligible securities.

Franklin Templeton argued that TALF loans would affect a fund's capital structure by creating leverage in a manner analogous to reverse repurchase agreements, and proposed to address the asset coverage requirements of Section 18 of the 1940 Act for a TALF loan in the manner set forth in SEC Release No. 10666. Accordingly, Franklin Templeton represented that each fund taking a TALF loan would maintain segregated liquid assets, marked-to-market daily, in an amount equal to the fund's outstanding principal and interest on the TALF loan, and would not use the eligible securities that collateralize its TALF loan to meet the asset segregation requirement. Effectively, this would ensure that a fund's borrowing under the TALF program would have asset coverage of at least 200%. The SEC Staff agreed not to recommend enforcement action if the fund participates in the TALF without treating the borrowing as a senior security representing indebtedness for purposes of compliance with Section 18 of the 1940 Act.

Because the TALF program is structured so that prospective borrowers may access it only through a primary dealer that acts as the borrower's agent and sole interface with the Federal Reserve Bank of New York and its custodian, the primary dealer may be called upon to hold fund assets in ways that would not comply with the custody provisions of the 1940 Act. The SEC Staff agreed that such an arrangement will not raise the safekeeping concerns underlying Rule 17f-1 or Section 17 of the 1940 Act.

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. In the period of adoption, a reporting entity must disclose any changes resulting from the application of the FSPs.

ENFORCEMENT ACTIONS

FINRA Fines Wachovia Securities $1.4 Million for Prospectus Delivery Failures

On June 25, 2009, FINRA announced that it fined Wachovia Securities, LLC $1.4 million for allegedly failing to deliver prospectuses and related material to customers who purchased investment products from Wachovia from July 2003 through December 2004 and for inadequate supervisory procedures.

According to FINRA, between July 2003 and December 2004, Wachovia failed to deliver prospectuses to customers in approximately 6,000 transactions with an estimated market value of $256 million. FINRA also found that Wachovia's supervisory policies and procedures were inadequate, because they failed to ensure that customers received prospectuses and did not provide for adequate oversight of Wachovia's outside vendors contracted to deliver prospectuses.

SEC Charges Madoff Solicitors and Feeder Funds with Fraud

On June 22, 2009, the SEC charged Cohmad Securities Corporation, as well as its chairman Maurice J. Cohn, chief operating officer Marcia B. Cohn and registered representative Robert M. Jaffe for actively marketing investment opportunities with Bernard L. Madoff while knowingly or recklessly disregarding facts indicating that Mr. Madoff was operating a fraud. In a separate complaint, the SEC charged California-based investment adviser Stanley Chais, who oversaw three feeder funds that invested all of their assets with Mr. Madoff.

The SEC alleged that the Cohmad defendants ignored and even participated in many suspicious practices that clearly indicated Mr. Madoff was engaged in fraud. For example, the SEC alleged that the defendants filed false Forms BD and FOCUS reports that concealed Cohmad's primary business of bringing in investors for Bernard L. Madoff Investment Securities LLC ("BMIS"). This referral business comprised as much as 90% of Cohmad's revenue in some years, bringing billions of dollars into BMIS' advisory business, for which BMIS paid them more than $100 million. The SEC also alleged that the compensation arrangement between BMIS and Cohmad indicated fraudulent conduct at BMIS: Cohmad was paid an annual percentage of the funds its representatives (except Mr. Jaffe) brought into BMIS offset by any withdrawals from those investor accounts, which indicated to Cohmad and the Cohns that BMIS was not providing any real returns to investors. The SEC alleged that Mr. Jaffe also participated in Mr. Madoff's fraud by, among other things, receiving compensation in the form of personal account returns from Mr. Madoff that Mr. Jaffe knew, or was reckless in not knowing, were manufactured by BMIS employees entering fictitious, backdated trades onto trade confirmations and account statements for his personal accounts at BMIS.

The SEC's complaint seeks injunctions, financial penalties and court orders requiring disgorgement of ill-gotten gains.

The SEC alleged that Mr. Chais committed fraud by misrepresenting his role in managing assets. According to the SEC, Mr. Chais held himself out as an investing wizard who managed hundreds of millions of dollars of investor funds, when, in reality, Mr. Chais was an unsophisticated investor who did nothing more than turn all of his funds' assets over to Mr. Madoff, while charging more than $250 million in fees for his purported "services." Additionally, the SEC charged Mr. Chais for distributing account statements that he should have known were false. For example, Mr. Chais allegedly told Mr. Madoff that he did not want there to be any losses on any of the funds' trades. According to the SEC, Mr. Madoff complied with Mr. Chais' request, and from 1999 to 2008, despite reportedly executing thousands of trades for Mr. Chais' accounts, Mr. Madoff did not report a loss on a single equity trade. The SEC's complaint seeks an injunction, a financial penalty and court orders requiring disgorgement of ill-gotten gains.

SEC Settles Charges Against Evergreen Fund Adviser and Distributor over Alleged Mispricing of Mortgage-Backed Securities

On June 8, 2009, the SEC charged Evergreen Investment Management Company LLC and Evergreen Investment Services, Inc., the adviser and distributor, respectively, of the Evergreen Ultra Short Opportunities Fund with securities law violations for overstating the value of a mutual fund that invested primarily in mortgage-backed securities, and then only selectively telling shareholders about the fund's valuation problems. The SEC found that the value of the fund, which was consistently ranked as a high performer in its class in 2007 and 2008, was inflated by as much as 17% due to Evergreen's improper valuation practices. According to the SEC, if the fund were properly valued, it would have ranked near the bottom of its category during this time.

The SEC found that, as early as February 2007, the fund's portfolio management team failed to take into account certain readily-available information when recommending valuations to the fund's valuation committee for certain mortgage-backed securities held by the fund. The SEC also found from at least July 25, 2007 to June 16, 2008, the fund's valuation committee valued one or more fund securities in accordance with prices obtained from a single broker-dealer, whose method for determining prices it had not reviewed or approved and, at certain times from March 2008 to June 2008, the fund's portfolio management team caused the fund to overstate its net asset value by withholding relevant negative information about one or more of the fund's fair-valued securities from the valuation committee.

According to the SEC, when Evergreen began to address the fund's overstated value by re-pricing certain holdings, it only disclosed the reasons and the likelihood for additional re-pricings to select shareholders, who were then able to cash out before incurring any additional drop in the value of their fund shares. Meanwhile, other shareholders were left uninformed. The adviser and distributor agreed to pay, jointly and severally, $33 million to compensate shareholders for harm caused by the conduct discussed above.

The adviser agreed to pay disgorgement of approximately $3 million and a civil penalty of $2 million. The distributor agreed to pay disgorgement of $1 and a civil penalty of $2 million.

SEC Settles Charges Against Investment Adviser Representative for Aiding and Abetting Merrill Lynch's Antifraud Violations

On June 8, 2009, the SEC settled charges against Michael A. Callaway, a Merrill Lynch investment adviser representative, for aiding and abetting Merrill Lynch's violation of the antifraud provisions of the Advisers Act. According to the SEC, from at least 2000 through 2005, Merrill Lynch, through its pension consulting services advisory program, breached its fiduciary duty to certain of the firm's pension fund clients and prospective clients by omitting to disclose material information. In providing advice to Merrill Lynch's pension fund clients, Mr. Callaway omitted to disclose to some of the firm's pension consulting clients that certain managers included in search results had not been vetted and approved in advance by Merrill Lynch Consulting Services. Mr. Callaway also failed to disclose material facts involving a conflict of interest inherent in clients' use of Merrill Lynch's transition management group. Mr. Callaway also failed to fully disclose facts that created a material conflict of interest inherent in recommending the use of directed brokerage to pay hard dollar fees when entering into an arrangement for directed brokerage. According to the SEC, Mr. Callaway's fee disclosure policies were consistent with those of Merrill Lynch and Merrill Lynch Consulting Services at the time and, after 2003, in some instances exceeded those policies. Furthermore, Mr. Callaway's conduct was allegedly known to Merrill Lynch and to Merrill Lynch Consulting Services, which never directed Mr. Callaway to make further disclosures. Mr. Callaway agreed pay a civil money penalty in the amount of $20,000.

SEC Settles Charges of Aiding and Abetting Adviser's Fraud with Two Former BISYS Officials

On May 28, 2009, the SEC announced its settlement with two former officials of BISYS Fund Services, Inc., Melissa M. Hurley and J. David Huber, for their involvement with undisclosed agreements between BISYS and certain mutual fund advisers. The SEC settled a related enforcement action against BISYS in September 2006. Ms. Hurley was an officer and general counsel of BISYS and Mr. Huber was the president from 1996 to March 1999, and managing director of BISYS from April 1999 to June 2005.

According to the SEC, Ms. Hurley reviewed draft side agreements, knew that the marketing arrangements should be disclosed to fund trustees and shareholders and did not disclose the terms of the side agreements to the fund trustees or shareholders. In 2003, Ms. Hurley also allegedly drafted a disclosure template concerning the marketing arrangements for certain fund shareholders and reviewed and commented on a disclosure template for certain fund boards of trustees, neither of which disclosed material facts such as the written nature of the agreements, the exchange of a portion of the administration fee for a recommendation to the fund board or the source of funds used for marketing. The SEC found that Ms. Hurley willfully aided and abetted and caused a fund adviser's violation of the antifraud provisions of the Advisers Act and ordered her to pay $35,569.22, consisting of disgorgement of $15,000, prejudgment interest of $5,569.22, and a civil money penalty of $15,000.

According to the SEC, Mr. Huber executed certain side agreements on behalf of BISYS, but did not disclose either the existence of the agreements or their terms to shareholders or the boards of trustees, including during discussions with the boards regarding renewing BISYS' contract. He also allegedly executed certain administration agreements on behalf of BISYS, even though such agreements did not contain information relating to the side agreements. The SEC found that Mr. Huber willfully aided and abetted and caused a fund adviser's violation of the antifraud provisions of the Advisers Act and ordered him to pay $18,000, consisting of disgorgement of $13,800 and prejudgment interest of $4,200.

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.

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