# Investment Services Regulatory Update

September 1, 2009

## NEW RULES, PROPOSED RULES AND GUIDANCE

### Massachusetts Proposes Amendments to Information Security Program Regulations and Compliance Deadline

On August 17, 2009, the Massachusetts Office of Consumer Affairs and Business Regulation published for comment proposed amendments to the regulations that require persons (including funds) who own or license personal information about a Massachusetts resident, such as a shareholder or employee, to develop, implement and maintain a comprehensive, written information security program, including a computer security system program. Under the amended regulations, "owns or licenses" is defined to include receiving, processing or otherwise accessing personal information. The revised regulations set forth a risk-based approach to information security, reflect that a number of the specific provisions previously required to be in the information security program were removed, apply technical feasibility to the computer security requirements and make the third-party vendor requirements consistent with federal law. A hearing on the proposed amendments is scheduled for September 22, 2009. The deadline for compliance with the proposed amended regulations is March 1, 2010.

### SEC Makes Short Sale Rule Permanent

On July 27, 2009, the SEC made permanent temporary Rule 204T (now Rule 204), which requires short sellers and their broker-dealers to deliver securities by the close of business on the settlement date for short sale transactions, and imposes penalties for the failure to do so. In the fall of 2008, the SEC had issued a series of orders and rules designed to curb "naked" short selling and to temporarily prohibit the short selling of stocks of certain financial companies because such practices have the potential to exacerbate market price movements. In a short sale transaction, a seller borrows a stock and sells it, with the understanding that the loan will be repaid by the seller by buying the stock on the open market. In a "naked" short sale transaction, the seller does not actually borrow the stock and fails to deliver it to the buyer. Noting that its temporary actions have largely had the intended effect of preventing substantial disruptions in the securities markets, the SEC adopted a permanent rule.

The SEC also allowed an interim final temporary rule requiring institutional investment managers (i.e., those who file or are required to file reports on Form 13-F) to report short sales of publicly-traded equity securities to expire on August 1, 2009. The rule required the filing of a Form SH on every Monday (or the first business day of the week if Monday is a federal holiday) with respect to any new short positions the manager had entered into during the prior seven-day period. The SEC indicated that it is working with self-regulatory organizations to make short sale volume and transaction data available through the organizations' websites.

**SEC Proposes New Rule to Curtail Adviser "Pay to Play" Practices**

On July 22, 2009, the SEC proposed a new rule intended to restrict "pay to play" practices by investment advisers seeking to manage money for state and local government public programs. The proposed rule is designed to prevent investment advisers from using direct political contributions and other pay to play arrangements to attempt to influence their selection by government officials.

Specifically, the proposed rule would:

- Subject to a de minimis provision for executives and employees of the adviser, bar an adviser who makes a political contribution to an elected official in a position to influence the selection of the adviser for two years from providing advisory services for compensation, either directly or through a fund;
- Prohibit an adviser from soliciting others to make contributions to an elected official or candidate who can influence the selection of the adviser or to a political party of a state or locality where the adviser is seeking to provide advisory services to the government;
- Prohibit an adviser from paying third party solicitors to solicit government clients on behalf of the adviser; and
- Prohibit an adviser from engaging in pay to play practices indirectly, for example, through affiliated companies, lawyers or spouses, if the conduct would violate the rule if the adviser did it directly.

Comments on the proposed rule are due by October 6, 2009.

**SEC Proposes Amendments to Enhance Corporate Governance Disclosures**

On July 1, 2009, the SEC proposed amendments to enhance corporate governance disclosures. The proposed amendments would require additional disclosure, if applicable, in fund proxy statements and SAIs regarding: (1) the qualifications of directors and nominees; (2) certain legal proceedings against directors or nominees; (3) the fund's leadership structure; and (4) the board's role in the risk management process.

Specifically, under the proposed amendments, a fund would be required to disclose for each director or nominee "the specific experience, qualifications, attributes, or skills that qualify that person to serve as a director for the Fund [and any committee thereof] at the time that the disclosure is made." This information may include a statement about the director's risk assessment skills and relevant areas of expertise. In addition, a fund would be required to disclose any directorships held by a director or nominee during the past five years with any public company or other fund, whether or not the director still

serves as a director of that company. The proposed disclosure amendments also would require a fund to disclose information regarding specified legal proceedings involving a director or nominee that occurred during the prior 10 years, rather than the prior five years as is currently required. Finally, under the proposed amendments, a fund would be required to describe its leadership structure, including a description of the responsibilities of the board and a statement as to whether the board has an independent chair. If the board chair is not independent, the fund would be required to disclose whether it has a lead independent director and the function of the lead independent director. In describing its leadership structure, the proposing release states that a fund should include a statement about why the leadership structure is appropriate in light of the specific characteristics of the fund. The description of a fund's leadership structure also would be required to include a statement about the extent of the board's role in the fund's risk management.

Comments on the proposal are due by September 15, 2009.

**SEC Approves NYSE Rule Amendments Eliminating Discretionary Voting in Uncontested Director Elections and Investment Advisory Contracts**

On July 1, 2009, the SEC approved a New York Stock Exchange proposal to amend NYSE Rule 452 to eliminate discretionary voting by brokers in any election of directors for all issuers *except* registered funds. Previously, the rule allowed brokers to vote on "routine" proposals, including uncontested director elections, when specific voting instructions were not provided by the beneficial owner at least 10 days prior to a scheduled meeting. The amendments to Rule 452 shift this classification to "non-routine," and thereby eliminate discretionary voting for uncontested director elections. The rule amendments do not apply to registered funds; thus, discretionary broker voting will still be permitted for uncontested director elections for funds.

The rule amendments also codify previous NYSE interpretations that prohibit discretionary broker voting in connection with material changes to a fund's investment advisory contract, including assignments of advisory contracts as a result of an adviser's change of control, or a fund's investment advisory contract with a new investment adviser.

**FINRA Proposes New Consolidated Rule on the Distribution and Sale of Investment Company Securities**

In June 2009, as part of the process of developing a new consolidated rulebook, FINRA proposed to replace Rule 2830, which regulates member firms' activities in the distribution and sale of investment company securities, with proposed FINRA Rule 2341. In its current form, NASD Rule 2830 regulates cash and non-cash compensation arrangements for the sale and distribution of fund shares and prohibits member firms from accepting "cash compensation" from an "offeror" (generally an investment

company, its adviser, distributor or their affiliates) unless such compensation is described in the fund's current prospectus. NASD Rule 2830 requires additional disclosure in the event an offeror makes "special cash compensation" arrangements with a member.

Proposed Rule 2341 would revise the disclosure requirements of NASD Rule 2830 for special cash compensation arrangements in several respects. The proposed rule would require prospectus disclosure relating to standard "sales charges and service fees," rather than "all cash compensation" as required in NASD Rule 2830. Proposed Rule 2341 also would remove the term "special cash compensation" from the current rule and instead require prospectus disclosure in situations where a member firm receives greater or special sales charges or service fees than are ordinarily paid by the offeror for the sale of the same fund shares. According to the proposed rule, a member firm has entered into a special sales charge or service fee arrangement if it receives from an offeror additional sales charges or service fees above the standard dealer reallowance or commission described in the investment company's prospectus, unless the prospectus makes clear that the additional compensation is being paid to all who sell the fund's shares.

The proposed rule also would require a member firm that receives cash payments in addition to the standard sales charges and service fees paid in connection with the sale of fund shares to make certain disclosures to its customers at the time accounts are opened, including: (1) that information about a fund's fees and expenses may be found in the fund's prospectus; (2) information relating to cash payments received in the last 12 months from offerors in addition to the standard sales charge and service fees disclosed in the prospectus; and (3) a reference to a web page or toll-free number containing updated information. For existing accounts, the disclosures would be required within 90 days of the effectiveness of the rule, or at the time the customer purchases fund shares after the effective date.

Proposed Rule 2341 also would make a minor change to the recordkeeping requirements for non-cash compensation. Among other things, NASD Rule 2830 requires member firms to keep records of all compensation received by member firms or their associated persons from offerors, other than small gifts and entertainment permitted by the rule. These records must include, "if known," the value of any non-cash compensation received. The proposed rule would delete the phrase "if known." Where a receipt or other documentation assigning value is not available, firms would be permitted to estimate in good faith the actual value of non-cash compensation.

Finally, FINRA Rule 2341 would codify earlier FINRA staff interpretive letters that permit the trading of ETF shares at prices other than the current net asset value consistent with applicable SEC rules or exemptive orders.

**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.

### Implementation of Identity Theft Prevention Programs Further Delayed Until November 1, 2009

On July 29, 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 imposes identity theft-related requirements on "financial institutions" and other specified entities, until November 1, 2009. This is the third time the FTC has delayed implementation of the rule.

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 November 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.

## PROPOSED LEGISLATION

### Legislation Proposed to Require Private Fund Advisers to Register with the SEC

On July 15, 2009, the U.S. Department of the Treasury proposed legislation entitled the "Private Fund Investment Advisers Registration Act of 2009" that would require all investment advisers to hedge funds and other private pools of capital, including private equity and venture capital funds, with more than $30 million of assets under management to register with the SEC. Currently, under the Advisers Act, an investment adviser is exempt from registration if during the preceding 12 months the adviser has

fewer than 15 clients (with each fund being considered one client) and does not hold itself out generally to the public or act as an investment adviser.

Also, on July 15, 2009, before the Subcommittee on Securities, Insurance and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Andrew "Buddy" Donohue testified that the SEC supports the registration of private fund advisers under the Advisers Act. He also discussed other legislative options, such as the registration of private funds under the 1940 Act and/or providing the SEC with rulemaking authority in the 1940 Act exemptions on which private funds rely, that he recommended be considered by the Subcommittee.

## OTHER NEWS

### SEC Provides No-Action Relief Permitting Foreign Funds to Invest in U.S. Funds in Excess of 1940 Act Limitations

On August 4, 2009, the SEC staff issued a no-action letter stating that it would not recommend enforcement action against a foreign fund that acquires shares of a registered U.S. fund in excess of the 5% and 10% anti-pyramiding limitations of Section 12(d)(1)(A) of the 1940 Act.

In granting the relief, the SEC staff relied on the following representations:

- each foreign fund will comply with the 3% restrictions of Section 12(d)(1)(A) of the 1940 Act;
- each foreign fund will not offer or sell securities in the U.S. or to any U.S. person;
- each foreign fund's transactions with its shareholders will be consistent with the definition of "offshore transactions" in Regulation S under the 1933 Act; and
- each U.S. fund will comply with the restrictions of Section 12(d)(1)(B) of the 1940 Act.

### SEC Issues No-Action Letter Related to Mixed and Shared Funding Orders

On July 31, 2009, the SEC's Division of Investment Management issued a no-action letter relating to "mixed and shared funding" exemptive orders for variable insurance products funds. Specifically, the no-action letter states that a fund would not have to comply with the terms and conditions of an existing mixed and shared funding order if the fund is not relying on the exemptions in the order. The terms and conditions of the existing order that the fund did not intend to comply with included restrictions regarding who can hold fund shares, in particular, college savings plans.

### 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.

## ENFORCEMENT ACTIONS

### SEC Charges Adviser and Its CEO for Fraudulently Overstating Assets

On August 13, 2009, the SEC charged Brantley Capital Management ("BCM"), investment adviser to Brantley Capital Corporation (a business development company) ("BCC"), and Robert Pinkas, chief executive officer of BCM, with securities fraud for overvaluing assets held by BCC in order to generate higher investment advisory fees.

According to the SEC, Mr. Pinkas and Tab Keplinger, BCM and BCC's part-time chief financial officer, substantially overstated the value of equity and debt investments in two failing private companies that represented more than half the investment portfolio of BCC, including equity of a private airline. The SEC alleged that Mr. Pinkas and Mr. Keplinger understood that the airline faced severe financial difficulties, and Mr. Pinkas knew that it was able to remain in business only because another investor repeatedly loaned the company money, yet Mr. Pinkas and Mr. Keplinger failed to disclose these financial difficulties to BCC's board and investors. The two also allegedly misrepresented the financial performance of the airline to BCC's board and its

independent auditors, cited various false rationales to support their $32.5 million valuation, and concealed third-party valuations that indicated BCC's investment was worth substantially less than what was being represented.

The SEC also alleged that the value of debt investments in another company was overstated. According to the SEC, Mr. Pinkas and Mr. Keplinger repeatedly advised BCC's board that the company would repay most of the loans provided by BCC, when in fact the company could not repay the loans. In addition, the company consistently missed its financial targets by large margins, remained in business only because BCC continued to loan it money, and lacked sufficient assets to cover BCC's loans in the event of liquidation. Despite knowing these facts and that the BCC's loans to the company were essentially worthless, Mr. Pinkas and Mr. Keplinger allegedly advised BCC's board that only relatively minor write-downs were required.

Mr. Keplinger agreed to settle the SEC's charges without admitting or denying the allegations and agreed to a $50,000 penalty and certain industry and professional bars. Mr. Pinkas and BCM are contesting the SEC's charges.

**FINRA Fines Merrill Lynch and UBS for Supervisory Failures in Sales of Closed-End Funds**

On July 28, 2009, FINRA announced that it fined Merrill Lynch, Pierce, Fenner & Smith, Inc. $150,000 and UBS Financial Services, Inc. $100,000 for alleged supervisory failures relating to unsuitable short-term sales of shares of closed-end funds ("CEFs") purchased in such funds' initial public offerings ("IPOs"). According to FINRA, Merrill and UBS failed to provide supervisors with guidance or warning about the potential abuses and disadvantages relating to short-term trading of CEF shares purchased during an IPO and failed to provide their registered persons with adequate guidance or training with respect to the impact of sales charges relating to short-term sales of CEF shares purchased in an IPO. Furthermore, FINRA found that neither Merrill nor UBS had adequate supervisory systems and procedures designed to detect and prevent unsuitable short-term trading of CEF shares.

**FINRA Fines Bank Broker-Dealers $1.65 Million for Supervisory Failures in Variable Annuity, Mutual Fund and UIT Transactions**

On July 23, 2009, FINRA announced that it fined McDonald Investments (now KeyBanc Capital Markets, Inc.), IFMG Securities, Wells Fargo Investments, LLC, PNC Investments and WM Financial Services, Inc. (now Chase Investment Services Corp.) $1.65 million for inadequate sales procedures and deficient supervision of sales activities relating to variable annuity, mutual fund and UIT transactions. According to FINRA, between 2004 and 2006 the firms engaged in a pattern of selling to elderly bank customers investment products which were either ineligible or inappropriate based on the customers' age. FINRA also found that the firms' supervisory procedures with respect to suitability were inadequate. For example, in some cases, the firms'

procedures failed to provide sales representatives with guidance on how to determine suitability in variable annuity transactions.

**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, at certain times in 2007 and 2008, the fund's portfolio management team failed to take into account readily available information concerning the value of the holdings, including the substantial weakening of a relevant index that served as a benchmark and data showing an increase in the default or delinquency rate of the mortgages backing the security, when recommending valuations to the fund's valuation committee for certain mortgage-backed securities held by the fund. The SEC also found that at times during 2007 and 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. With respect to using prices obtained from the single broker-dealer, the SEC found that, on various occasions, third-party pricing vendors reduced prices on securities held by the fund, but rather than reducing the prices for purposes of calculating the fund's NAV, the portfolio management team recommended – and the valuation committee approved – vendor overrides, through which the fund valued the securities in question using the price obtained from the single broker-dealer. Finally, the SEC found that in May 2008, the fund continued to value a security at $98.93, even though another Evergreen mutual fund purchased the security for $9.50 under circumstances that did not support a "distressed sale" finding.

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.

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