Investment Services Regulatory Update

January 4, 2010

LITIGATION

Court Rules in Favor of American Funds in Fee Case

On December 28, 2009, a Los Angeles federal district court ruled in favor of the defendants in the *American Mutual Funds Fee Litigation* case. Applying the *Gartenberg* standard to the plaintiff's excessive fee claims under Section 36(b) of the 1940 Act, the court held that the plaintiffs failed to sustain their burden of proving that the fees charged were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been a product of arm's-length bargaining. In citing *Gartenberg*, the court stated that the *Jones v. Harris Associates* standard is flawed because it ignores the plain language of Section 36(b) and essentially emasculates the statute. The court also stated that the *Gallus v. Ameriprise Financial* standard is flawed because it expands Section 36(b), providing for a cause of action even where a challenged fee passed muster under the *Gartenberg* standard.

As an aside, the court noted that the *Gartenberg* standard is a very high threshold for a plaintiff to overcome and that its holding should not be mistaken for a determination that the directors obtained the best possible deal for investors as suggested in the defendants' proposed findings and conclusions of law. The court quoted Judge Posner's dissent in *Jones* and observed that the directors had little incentive to police the compensation paid to the defendants. For instance, the court noted that the directors were never provided data showing the compensation paid to employees of the defendants as part of their review of profitability.

U.S. Supreme Court Hears *Jones v. Harris Associates*

On November 2, 2009, the U.S. Supreme Court heard oral arguments in *Jones v. Harris Associates*, a closely-watched case concerning the appropriate standard for reviewing excessive fee claims arising under Section 36(b) of the 1940 Act. The *Jones* case was elevated to the U.S. Supreme Court after the Seventh Circuit, in May 2008, 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." Prior to the Seventh Circuit ruling, the *Gartenberg* standard had prevailed unchallenged for over 25 years.

While the bench appeared to have myriad questions, they all seemed to revolve around only a handful of themes. That is, the Court's questions seemed to focus on the nature of the fiduciary duty imposed on investment advisers by Section 36(b), whether investment advisers were justified in charging different fees to institutional clients and mutual funds, the appropriate role of the courts in reviewing investment advisory fees and the amount of deference that should be provided to a fund's board in negotiating and determining such fees.

Chief Justice Roberts and Justice Scalia seemed averse to the idea of a more rigorous judicial review of investment advisory fees and even suggested that investors may not need to rely on courts for protection from allegedly excessive fees. Chief Justice Roberts remarked that investors could very easily track the fees of a fund in which they invest and, in the event they are unhappy, could simply move their funds. “It takes 30 seconds,” he added. Moments later, Justice Scalia went further, stating: “[W]hen investors leave the company that is charging excessive fees to go to other companies, the company that they are leaving sees that something is wrong and has to lower its compensation to its adviser.”

Separately, Justice Breyer suggested that, in reviewing excessive fee cases arising under Section 36(b), it may be appropriate for judges to compare the fees charged by an investment adviser to its institutional clients and mutual funds, referring to such comparison as “a normal question to ask.” Justices Kennedy’s and Sotomayor’s questions seemed to focus on the nature of the fiduciary duty imposed on investment advisers by Section 36(b) and whether the standard for investment advisers should be the same as or different from other fiduciaries.

Interestingly, none of the litigants embraced the Seventh Circuit approach in presenting their oral argument, as the respondent, Harris Associates, sought affirmance of the Seventh Circuit decision on alternative grounds. Both litigants, however, embraced the *Gartenberg* standard, albeit their respective versions of that standard.

The U.S. Supreme Court is expected to issue a decision in the *Jones* case in the first half of 2010.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Adopts Amendments to Investment Adviser Custody Rule

On December 30, 2009, the SEC adopted amendments to Rule 206(4)-2 under the Advisers Act, which regulates the custody practices of registered investment advisers. The SEC also adopted related amendments to Form ADV and Form ADV-E. The amendments, which will become effective 60 days after their publication in the Federal Register, are intended to improve the safekeeping of client assets when an adviser has custody of client funds and/or securities. The SEC has amended Rule 206(4)-2 by:

- Requiring that all advisers with custody of client assets engage an independent public accountant to conduct an annual surprise examination of client assets. (This requirement will not apply to advisers with custody of client assets solely because of their authority to deduct fees from client accounts or to advisers to pooled investment vehicles that are already subject to an annual audit.)

- Requiring 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: (1) conduct a surprise examination, with the first of such examinations to occur by December 31, 2010; (2) notify the SEC within one business day of finding a material discrepancy; (3) submit Form ADV-E to the SEC within 120 days of the time chosen for the surprise examination; and (4) submit Form ADV-E to the SEC within four business days of the accountant's resignation from or termination of the engagement.

- Making privately-offered securities (as defined in the Rule) that advisers hold on behalf of their clients subject to the surprise examination.

- Providing 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.

- Requiring that when an adviser or a related person serves as a qualified custodian for client assets, the adviser 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 regarding 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).

- Requiring that when an adviser or a related person serves as a qualified custodian for client assets, the annual surprise examination be performed by an independent public accountant registered with the PCAOB.

- Requiring 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.

- Requiring advisers that send account statements separate from the ones the custodian delivers 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.

Registered advisers must provide responses to the revised Form ADV in their first annual amendment after January 1, 2011.

SEC Extends Temporary Rule Regarding Adviser Principal Trades

On December 23, 2009, the SEC extended by one year the temporary rule that provides an alternative method for investment advisers who are also broker-dealers to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Temporary Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. Pursuant to Rule 206(3)-3T, which will now expire on December 31, 2010, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; and (3) provides the client with an annual report on all principal transactions. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC made no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension was necessary to give the SEC additional time to evaluate the operation of the Rule.

SEC Reopens Comment Period on Proposed Amendments to Proxy Rules to Facilitate Rights of Shareholders to Nominate Directors

On December 18, 2009, the SEC re-opened the comment period on proposed amendments to the proxy rules to enhance the rights of shareholders to nominate directors for corporate boards, including boards of investment companies, to permit further comment on additional data and related analyses regarding the proposed amendments that have been included in the public comment file subsequent to the close of the initial comment period. Under the amendments which were proposed on May 20, 2009, 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 knew or had reason to know the information is false or misleading.

The additional comment period ends on January 19, 2010.

SEC Adopts New Disclosure Requirements for Board Governance Matters

On December 16, 2009, the SEC adopted amendments to the rules governing proxy statement disclosure and to the forms for fund registration statements that significantly expand the information that funds must disclose regarding certain board governance matters. The amendments become effective on February 28, 2010 and require enhancements to proxy statement disclosure in the following areas: (1) the board's leadership structure; (2) the board's role in risk oversight; (3) the qualifications and experience of directors and director nominees; (4) prior directorships; (5) directors' prior legal and disciplinary actions; and (6) the role of diversity in considering board candidates.

With respect to registration statement disclosure, the amendments apply to disclosure regarding the management of funds included in the SAI. The SAI amendments mirror the proxy statement amendments, but do not require the enhanced disclosure regarding directors' prior legal and disciplinary actions or the role of diversity in considering board candidates.

Specifically, under the amendments, funds must describe the funds' 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, funds are required to disclose whether they have a lead independent director and the function of the lead independent director. In describing their leadership structure, funds must also include a statement about why the leadership structure is appropriate in light of the specific characteristics of the funds. With respect to the required disclosure regarding the board's role in risk oversight, funds must describe how the board

administers its risk oversight function, whether through the whole board or through a committee.

The amendments also require funds to disclose for each director or nominee (i.e., including those directors *not* up for election), the particular experience, qualifications, attributes or skills that led the board to conclude that the person should serve as a director. In addition, if an individual is chosen to be a director or a nominee because of specific expertise related to service on a specific committee (such as the audit committee), then this information should be disclosed as part of the discussion of the person's qualifications to serve on the board. In addition, funds must 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 entity. For proxy statements, the disclosure amendments also require a fund to disclose information regarding specified legal proceedings involving a director or nominee that occurred during the prior ten years, rather than the prior five years as is currently required.

Finally, the amendments require funds to disclose in proxy statements whether, and if so how, a nominating committee considers diversity in identifying nominees for director. If the board or the nominating committee has a policy regarding the consideration of diversity, funds must also disclose how this policy is implemented and how the board or committee assesses the policy's effectiveness. The amendments do not define diversity, but instead allow funds to define diversity as they consider appropriate (such as on the basis of varied professional experience, education, skill, race or gender).

The SEC's Division of Investment Management has published guidance to assist funds in determining when they are required to implement the disclosure amendments based, among other things, on a fund's fiscal year-end.

Federal Regulatory Agencies Issue Model Privacy Notice Form

On November 17, 2009, eight federal regulatory agencies, including the SEC, released a final model privacy notice form that is designed to make it easier for consumers to understand how financial institutions collect and share nonpublic personal information. Since 2001, under rules adopted pursuant to the Gramm-Leach-Bliley Act, financial institutions, including funds and registered investment advisers, have been required to provide a privacy notice to their shareholders and clients initially when a relationship is formed and annually thereafter. Recognizing that privacy notices are often long and complex, Congress directed the regulatory agencies to develop a model form that would be succinct and easy for consumers to use and understand. Use of the model form issued by the agencies is optional, but those institutions that choose to use the model form will obtain a "safe harbor" and will be deemed to satisfy the disclosure requirements for privacy notices.

SEC Adopts Regulation S-AM

Effective September 10, 2009, the SEC adopted Regulation S-AM, which addresses affiliate marketing through the use of consumer information. Regulation S-AM is designed to prevent registered investment advisers, investment companies, broker-dealers and registered transfer agents ("covered persons") from using certain consumer information provided by a covered person's affiliate to market products or services, unless a clear and conspicuous notice is provided to the consumer disclosing that the covered person may use such information and the consumer does not "opt out" of such marketing after receiving the notice. No specific form is required for the consumer notice, but it must include the names of the affiliate(s) providing the notice, the types of eligibility information that may be used in solicitations and the length of time that the "opt out" provision will remain effective, which must be at least five years. The appendix to the SEC's adopting release contains model forms that satisfy Regulation S-AM's requirement of a clear, conspicuous notice. The notice can be combined with other disclosures required by law (such as the initial and annual privacy notices required by Regulation S-P). Regulation S-AM also contains a number of exceptions to its notice and opt out requirements, including when an affiliate making a marketing solicitation has a pre-existing business relationship with a consumer or provides marketing material in response to a request by the consumer or in response to a communication initiated by the consumer.

The compliance date for Regulation S-AM has been extended from January 1, 2010 to June 1, 2010.

Massachusetts Publishes Final Information Security Program Regulations

In October 2009, the Massachusetts Office of Consumer Affairs and Business Regulation published the final version of the regulations that require persons (including funds) who own or license (which includes receiving, storing, maintaining, processing or otherwise accessing) 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. The revised regulations (1) define service provider to include any person that receives, stores, maintains, processes or otherwise has access to personal information as a result of providing services directly to a person subject to the regulations and (2) clarify that third-party service provider contracts entered into no later than March 1, 2010 have until March 1, 2012 to amend their terms to comply with the regulations. Otherwise, the compliance deadline continues to be March 1, 2010.

Implementation of Identity Theft Prevention Programs Further Delayed Until June 1, 2010

On October 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 imposes identity theft-related requirements on "financial institutions" and

other specified entities, until June 1, 2010. This was the fourth time the FTC delayed implementation of the rule.

SEC Proposes Amendments to Rules Requiring Internet Availability of Proxy Materials

On October 14, 2009, the SEC proposed changes to the proxy rules to improve the notice and access model for furnishing proxy materials to shareholders. The SEC noted that preliminary data on issuers using the notice-only option under the notice and access model indicated that such issuers had lower shareholder response rates to their proxy solicitations. The proposed amendments would allow issuers additional flexibility in formatting and selecting language to be used in the Notice of Internet Availability of Proxy Materials sent to shareholders as part of the notice-only option. Under the proposed amendments, the proxy rules would identify certain topics required to be covered in the notice, but would not specify the exact language to be used. In addition, to improve shareholder understanding of the notice, the notice could be accompanied with an explanation of the notice and access model.

The proposed rule amendments also seek to make it easier for a soliciting person other than the issuer to use the notice-only option under the notice and access model. Under the current rules, a soliciting person who is not the issuer must send its notice to shareholders either 40 calendar days before the shareholder meeting or 10 calendar days after the issuer first sends its notice or proxy statement to shareholders. The SEC noted that a soliciting person may not be able to send its notice within 10 calendar days after the issuer first sends its notice or proxy statement due to the SEC staff's current practice of reviewing and commenting on proxy materials. To address this issue, the SEC proposed to amend the proxy rules to allow a soliciting person other than the issuer using the notice-only option to timely deliver a notice to shareholders if the soliciting person files a preliminary proxy statement within 10 days of the issuer filing its definitive proxy statement and sends its notice to shareholders no later than the date on which it files its definitive proxy statement.

SEC Proposes Rules to Enhance Credit Ratings Disclosure

On October 7, 2009, the SEC proposed amendments to various rules and forms under the 1933 Act, the 1934 Act and the 1940 Act to require registrants to disclose information regarding credit ratings used in connection with a registered offering of securities. The proposed amendments would apply to closed-end funds that use a credit rating with respect to a class of securities issued by the fund. Specifically, the SEC proposed to amend Form N-2 to require additional disclosure about a credit rating used in connection with the offering of a class of securities of a closed-end fund, including disclosure of all material limitations on the scope of the credit rating and disclosure of potential conflicts of interest, including the source of payment for the credit rating. In addition to the disclosure regarding credit ratings included in Form N-2, closed-end funds would be required to disclose any changes to a credit rating that was used with respect to a class of securities issued by the fund. Under the proposed amendments,

closed-end funds would be required to file a Form 8-K disclosing the credit rating changes unless substantially similar information as would be required in the Form 8-K was made publicly available through a press release.

SEC Removes Rule References to Nationally Recognized Statistical Rating Organizations

On October 5, 2009, the SEC adopted amendments to 1934 Act and 1940 Act rules to remove references to nationally recognized statistical rating organizations ("NRSROs"), as part of the SEC's effort to address concerns that references to NRSROs in SEC rules may have contributed to an undue reliance by market participants on the ratings issued by NRSROs. The changes most relevant for funds are to Rules 10f-3 and 5b-3 under the 1940 Act.

Rule 10f-3 permits a fund that is affiliated with a member of an underwriting syndicate to purchase securities from the syndicate if certain conditions are met. In the rule amendments, the SEC revised the criteria for municipal securities that may be purchased in reliance on the rule by removing references to NRSRO ratings in favor of criteria based upon a particular security's liquidity and credit quality. The process for fund boards approving appropriate procedures and reviewing 10f-3 purchases on a regular basis was not changed by the amendments.

Rule 5b-3 under the 1940 Act relates to Section 5(b)(1) of the Act, which limits the amount that a diversified fund may invest in the securities of any one issuer, other than the U.S. government. For purposes of diversification requirements, Rule 5b-3 equates the acquisition of "refunded securities" (i.e., debt securities whose principal and interest payments are to be paid by U.S. government securities placed in an escrow account) with the acquisition of the escrowed government securities, provided that certain conditions are met. One condition requires funds to obtain an independent accountant's certification relating to refunded securities to be purchased, unless the securities have received a debt rating in the highest category from an NRSRO. In the rule amendments, the SEC eliminated this NRSRO rating exception, and an independent accountant's certification must now be obtained regardless of a refunded security's rating.

The rule amendments became effective on November 12, 2009.

NEW LEGISLATION

Congressmen Introduce Regulated Investment Company Modernization Act of 2009

On December 16, 2009, Chairman of the Ways and Means Committee, Charles Rangel, along with representatives Joseph Crowley, Richard Neal and Allyson Schwartz, introduced the Regulated Investment Company Modernization Act of 2009, which would amend the Internal Revenue Code to modify certain rules governing the taxation of regulated investment companies. The Act would conform certain tax rules applicable to

funds to similar rules applicable to individuals or real estate investment trusts. Among other provisions, the Act would: (1) permit unlimited net capital loss carryforwards, (2) include income from commodities as a source of good income, (3) permit funds to cure inadvertent failures to comply with gross income and gross asset tests and (4) modify rules related to distributions, dividends and the annual excise tax. The Act has been referred to the House Committee on Ways and Means.

House Approves Wall Street Reform and Consumer Protection Act of 2009

On December 11, 2009, the House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, which is a broad compilation of legislation introduced throughout 2009. Among other provisions, the Act would:

- establish a Financial Services Oversight Council comprised primarily of the heads of various financial regulatory entities that would monitor and identify potential threats to the stability of the U.S. financial markets, resolve disputes among federal financial regulatory entities and, together with the Federal Reserve or other applicable federal regulator, impose stricter prudential standards on any financial company, activity or practice that poses a threat to the stability of the markets;

- provide that, unless exempted by the SEC, an issuer of a security registered under Section 12 of the Exchange Act is required to submit its executive compensation to shareholders for non-binding approval during any proxy solicitation related to such securities;

- require investment advisers of certain unregistered investment companies (i.e., 3(c)(1) and 3(c)(7) funds) to register with and provide information to the SEC;

- hold broker-dealers who provide investment advice to retail customers to the same standard of care as investment advisers;

- authorize the SEC to assess a fee on federally-registered investment advisers to fund inspections and examinations;

- authorize the SEC to prescribe rules and regulations requiring the inclusion of shareholder-proposed board nominees in issuer proxy solicitations;

- permit the SEC to limit the use of pre-dispute arbitration provisions in broker-dealer agreements; and

- subject auditors of broker-dealers to regulation by the Public Company Accounting Oversight Board.

Senator Introduces Mutual Fund Transparency Act of 2009

On October 28, 2009, Senator Daniel K. Akaka introduced the Mutual Fund Transparency Act of 2009, which would require broker-dealers to disclose in writing to their customers purchasing shares of registered funds the source and amount of compensation that such broker-dealers receive in connection with the sale of fund shares, including revenue sharing payments, as well as comparative data for comparable transactions. The Act also would require funds to include in any regulatory filings disclosing fees and expenses the amount of brokerage commissions paid by the funds during the previous five years. In addition to the disclosure requirements, the Act would require (1) 75% of a fund's directors to be independent, (2) a fund board to have an independent chairman and (3) the election of independent directors by shareholders at least once every five years.

OTHER NEWS

Director of SEC's Division of Investment Management Comments on Independent Director Issues at IDC Conference

In the keynote address at the IDC Investment Company Directors Conference on November 12, 2009, the Director of the Division of Investment Management, Andrew J. ("Buddy") Donohue, discussed various challenges faced by independent directors in exercising their oversight duties, focusing primarily on issues faced by closed-end fund independent directors when determining actions to take in response to fund takeover attempts. Mr. Donohue highlighted five specific actions that have been taken by fund boards in response to takeover attempts and stressed that, when considering such actions, directors must ultimately determine whether the action is in the best interests of the fund and its shareholders.

The actions discussed by Mr. Donohue were (1) the adoption of a shareholder rights plan, commonly known as a "poison pill," (2) the use of state law "control share" statutes to restrict the ability of large shareholders to vote their shares at shareholder meetings, (3) delaying a fund's annual meeting, (4) requiring the affirmative vote of a majority of outstanding shares for the election of directors and (5) adopting a by-law that imposes certain requirements for director candidates, while exempting a fund's current directors (including those affiliated with fund management) from such requirements. In discussing these actions, Mr. Donohue stated that, although fund management may for various reasons advocate taking one or more of such actions in response to a takeover attempt, the fund's board must always consider whether the action is in the best interests of the fund and its shareholders.

In addition to the challenges faced by closed-end fund independent directors in connection with takeover attempts, Mr. Donohue addressed (1) expense recapture, (2) fund mergers, (3) fulcrum fees, and (4) "yield" and managed distribution plans. In discussing the staff's position on expense recapture (i.e., clawbacks), Mr. Donohue stated that a "fund's expense ratio should be below the expense cap upon which the

waiver was initially based in order for the adviser to recapture the difference between the lower ratio and the expense cap."

In discussing fund mergers, Mr. Donohue expressed concern that certain fund mergers were being carried out for the sole purpose of merging away a fund with poor performance and that, in some cases, the performance used for the combined fund was that of the acquiring fund, which was the relatively newer fund, the fund with less assets or the fund with shareholders affiliated with the adviser. Mr. Donohue suggested that directors consider the impact a fund merger would have on an acquired fund's shareholders in order to make sure that the fund merger is in the best interests of such shareholders.

Mr. Donohue also stated that directors must carefully consider the implementation of fulcrum (or performance-based) fees and clearly understand what the fulcrum fee represents, including the possibility that an adviser may owe a fund money under certain conditions. Mr. Donohue noted that some funds have tried implementing a floor total fee without proportionally limiting an adviser's upside, which is not permissible because the incentive adjustments must be symmetrical.

Finally, Mr. Donohue discussed disclosures regarding a fund's yield or managed distribution plan. Mr. Donohue stated that directors must make sure that a fund's disclosures explain what the distribution yield represents and that it is not to be confused with actual investment performance. He also stated that directors should consider whether managed distribution plans continue to be in the best interests of shareholders. Mr. Donohue pointed out that the SEC staff has noted inconsistencies between Rule 19a-1 notices and other information posted on a fund's website and that no additional disclosure was provided to explain such inconsistencies. Mr. Donohue suggested that directors review their fund's disclosures to make sure that the information is disclosed consistently or to provide disclosure for any inconsistencies.

The full text of Mr. Donohue's speech is available on the SEC's website at http://www.sec.gov/news/speech/2009/spch111209ajd.htm.

ENFORCEMENT ACTIONS

SEC Charges U.S. Subsidiary of World's Largest Inter-Dealer Broker for Displaying Fictitious Trades and Misleading Customers

On December 18, 2009, the SEC charged a U.S. subsidiary of the world's largest inter-dealer broker, U.K.-based ICAP plc, with fraud for engaging in deceptive activity and making material misrepresentations to customers concerning its trading activities. According to the SEC, ICAP's U.S. Treasuries ("UST") brokers displayed thousands of fictitious flash trades to ICAP's customers between December 2004 and December 2005. The SEC also found that ICAP represented to its off-the-run UST customers that its electronic trading system would follow certain workup protocols in handling customer orders. However, ICAP's brokers on the UST desks used manual

tickets to bypass such protocols and close out of thousands of positions in their ICAP house accounts, thereby rendering ICAP's representations concerning the workup protocols false and misleading. In some instances, ICAP's customers' orders received different treatment than the customers expected pursuant to the workup protocols.

The SEC also found that ICAP held itself out as a firm that did not engage in proprietary trading. The SEC alleged that during the relevant period, however, two former ICAP brokers on the voice-brokered collateralized pass-through mortgage-backed securities ("MBS") desk routinely engaged in profit-seeking proprietary trading that rendered ICAP's representations regarding proprietary trading false and misleading. The SEC's order found that ICAP failed to make and keep certain required books and records on the UST desks and the MBS desk. ICAP agreed to settle the SEC's charges by, among other things, paying $25 million in disgorgement and penalties. The SEC also charged five ICAP brokers for aiding and abetting the firm's fraudulent conduct and two senior executives for failing reasonably to supervise the brokers. The individuals have agreed to pay penalties to settle the SEC's charges.

SEC Charges Investment Adviser and COO for Trade Allocation Violations

On December 14, 2009, the SEC charged investment adviser Ark Asset Management Co., Inc., and Stephen Jay Mermelstein, Ark's COO, for trade allocation violations. According to the SEC's order, a portfolio manager at Ark favored the NorthStar Funds (hedge funds) over the client accounts in the allocation of securities between August 2000 and December 2003.

According to the SEC, the portfolio manager placed orders for securities, but changed or delayed making allocations of the purchases and sales until after the order had been filled, which allowed the portfolio manager to allocate more favorable trades to the hedge funds. As a result of this fraudulent conduct, according to the SEC, Ark realized at least $19 million of ill-gotten gains in the form of performance fees from the hedge funds.

According to the SEC, when placing trades, neither the portfolio manager nor the traders who worked for him documented how the trade would ultimately be allocated between the two sets of accounts. While each set of accounts had different order tickets, orders were routinely written on an order ticket for one of the two sets of accounts. The order tickets, however, allegedly did not reflect how the portfolio manager would ultimately decide to allocate the securities, and in some instances, traders were directed to move an order from one set of accounts to the other by creating a new order ticket, transferring the security to that ticket and discarding the old order ticket.

Ark is required to file an answer to the SEC's order within 20 days after service of the SEC's complaint. Mr. Mermelstein has agreed to pay a civil money penalty in the amount of $50,000.

FINRA Fines Terra Nova Financial $400,000 for Improper Soft Dollar Payments

On November 23, 2009, FINRA announced that it fined Terra Nova Financial, LLC $400,000 for allegedly making more than $1 million in improper soft dollar payments to or on behalf of five hedge fund managers, failing to supervise its soft dollar program and failing to implement adequate supervisory procedures. FINRA also sanctioned the three Terra Nova employees who were primarily responsible for the implementation and oversight of Terra Nova's soft dollar program.

According to FINRA, Terra Nova made numerous soft dollar payments on behalf of five hedge funds between 2004 and 2005 which were not authorized by fund documents. The payments were used to pay for, among other things, various entertainment expenses and unauthorized employee salaries and consulting fees.

In addition to the fine, Terra Nova is required to retain an independent consultant to review and enhance its policies, systems and procedures relating to its soft dollar operations.

SEC Charges Investment Adviser and Two Senior Officers for $24 Million Fraudulent Scheme

On November 4, 2009, the SEC charged Value Line Inc. (an investment adviser), Jean Buttner, Value Line's CEO, David Henigson, Value Line's former chief compliance officer, and Value Line Securities, Inc., Value Line's affiliated broker-dealer, with defrauding the Value Line family of mutual funds by charging over $24 million in bogus brokerage commissions on mutual fund trades funneled through Value Line Securities.

The SEC alleged that, from 1986 to 2004, Value Line directed a portion of the funds' securities trades to Value Line Securities through a "commission recapture program." In the commission recapture program, Value Line arranged for one of three unaffiliated brokers to execute, clear and settle the funds' trades at a discounted commission rate. Instead of passing the discounted rate to the funds, the unaffiliated brokers allegedly billed the funds the standard rate and then "rebated" the difference between the standard rate and the discount rate to Value Line Securities. In total, Value Line Securities received over $24 million in brokerage commissions from the funds pursuant to this scheme; Value Line Securities did not perform any bona fide brokerage services for the funds on these trades.

The SEC also alleged that, through Ms. Buttner and Mr. Henigson, Value Line falsely represented to the Value Line funds' independent directors and shareholders that Value Line Securities provided bona fide brokerage services for the commissions it received and that Value Line Securities otherwise served the best interests of the funds and their shareholders. According to the SEC, Ms. Buttner directed the "commission recapture program" and monitored its profitability to Value Line Securities, and thus to Value Line, by receiving periodic updates from Mr. Henigson, who was responsible for implementing

the scheme. Ms. Buttner and Mr. Henigson were also involved in structuring and negotiating the recapture arrangement with the unaffiliated rebate brokers.

As a result of these allegations, Value Line agreed to pay $24,168,979 in disgorgement, $9,536,786 in prejudgment interest and a $10 million penalty. Ms. Buttner and Mr. Henigson agreed to pay $1 million and $250,000 in penalties, respectively. In addition, Ms. Buttner and Mr. Henigson were each barred from association with any broker, dealer, investment adviser or investment company and were prohibited from acting as an officer or director of any public company.

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