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REGULATORY ADMINISTRATION DIGEST

A summary of mutual fund regulatory updates for the fourth quarter of 2008

The Federal Reserve began funding the MMIFF program on November 28, 2008, for eligible investors.

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Federal Reserve Announces Money Market Investor Funding Facility

On October 21, 2008, the Federal Reserve Board announced the creation of the Money Market Investor Funding Facility (MMIFF). The MMIFF is intended to serve as a source of liquidity to money market funds increasing the funds' ability to meet redemption requests and invest in other money market instruments. Under the facility, the Federal Reserve Bank of New York (New York Fed) will provide senior secured funding to five private sector special purpose vehicles (PSPVs) to facilitate the purchase of high-quality money market instruments from eligible investors. Eligible assets include U.S. dollar-denominated certificates of deposit and commercial paper issued by highly rated financial institutions having remaining maturities of 90 days or less and must be issued by an institution included on a specified list of 50 banks, bank holding companies and captive finance companies. Eligible investors currently include U.S. money market mutual funds and over time may include other U.S. money market investors.

Each PSPV will purchase eligible assets from money market funds at amortized cost. A PSPV will only purchase debt instruments issued by the ten financial institutions it designates in its operational documents. Each PSPV will finance 90% of the purchase price of an eligible asset by borrowing from the New York Fed under the MMIFF and will finance the remaining 10% by selling asset-backed commercial paper (ABCP). In other words, money market funds that sell eligible assets to a PSPV will receive 90% of the asset's amortized cost in cash and 10% in ABCP. The ABCP will bear interest at approximately 25 basis points (0.25%) less than the rate on the asset sold; will have a maturity equal to the maturity of the asset sold; and will be rated at least A-1/P-1/F1 by two or more major Nationally Recognized Statistical Ratings Organizations (NRSROs). The New York Fed loans will be senior to the ABCP and secured by the assets of the PSPV. Any default on an asset held by a PSPV will suspend principal and interest payments on the ABCP until all PSPV assets have matured and the New York Fed loans are repaid. Any remaining cash will be used to repay the principal and interest on the ABCP.

The New York Fed will extend loans to the PSPVs at the primary credit rate. In order to reduce the interest rate risk to the PSPVs, however, the New York Fed has agreed to subordinate its right to receive interest payments to the rights of the ABCP holders to receive principal and interest if the primary credit rate rises above 2.25%. Any accumulated income in a PSPV not distributed to the investors will accrue to the New York Fed. When a PSPV is wound down, each eligible investor that sold assets to the PSPVs will have the right to receive a contingent distribution of funds, to the extent there is additional available income in the PSPV. The contingent distribution will increase the total yield to the investor up to 25 basis points (0.25%) above the yield on the assets it sold to the PSPV or 50 basis points (0.50%) above the ABCP's stated rate. The right to receive any contingent distributions applies only to eligible investors who sell assets to the PSPVs, is not transferable, and does not apply to persons who purchase ABCP in the secondary market

Northern Trust

J.P. Morgan Securities Inc. will serve as the PSPVs' structuring and referral agent, and JPMorgan Chase Bank, N.A. will be the collateral agent, depository and issuing and paying agent.

Two Federal Money Market Support Programs Extended

The Secretary of the Treasury has the option to extend the Temporary Guarantee Program for Money Market Funds until September 19, 2009, but no decision has been made to extend the program beyond April 30, 2009, at this time.

On November 24, 2008, the U.S. Treasury Department announced that it would extend the Temporary Guarantee Program for Money Market Funds until April 30, 2009. All money market funds that originally elected to participate in the program and met the extension requirements were eligible to continue to participate. The program provides uncapped coverage to shareholders for shares held in participating funds as of September 19, 2008.

Initially, all money market mutual funds regulated under Rule 2a-7 of the Investment Company Act of 1940 that had a market-based net asset value (NAV) of at least $0.995 on September 19, 2008 were eligible to participate in the program. Funds that wished to obtain extended coverage must have elected to participate in the extension and paid the new Program Participation Fee (updated to between 0.015% and 0.022% of NAV on September 19, 2008) by December 5, 2008.

On December 2, 2008, the Federal Reserve announced it would continue the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility until April 30, 2009. This program allows the Federal Reserve to extend non-recourse loans to U.S depository institutions, bank holding companies and U.S. branches of foreign banks to finance the purchase of asset-based commercial paper (ABCP) from money market mutual funds at amortized cost. The ABCP must qualify as a Rated Security and First Tier Security under Rule 2a-7; be issued in U.S. dollar denomination by a U.S. issuer under an ABCP program in existence as of September 18, 2008; and have a maturity of less than 270 days. Banks are allowed to use any ABCP purchased on or after September 19 as collateral for the loans. Previously the program was scheduled to stop making new loans on January 30, 2009.

These two federal programs have been implemented to provide support for money market funds in danger of "breaking the buck." "Breaking the buck" occurs when a money market fund is unable to repay investors a $1.00 NAV per share. The programs were announced after three of Reserve Management Corporation's money market funds reported NAVs of less than $1.00. The two programs are intended to enhance confidence in the money market industry and curtail mass shareholder redemptions, in an effort to ensure that money market funds will be able to maintain a NAV of $1.00.

SEC Adopts Summary Prospectus Proposal

On November 19, 2008, the Securities and Exchange Commission (SEC) adopted amendments to Form N-1A, the registration form for mutual funds. These amendments require every mutual fund to include key information in a summary section at the front of its statutory prospectus about the fund's investment objectives and strategies, risks, and costs. The summary section must be written in plain English in a standardized order and

The rule amendments will allow mutual funds to satisfy prospectus delivery requirements under Section 5(b)(2) of the Securities Act of 1933 by sending a summary prospectus in lieu of the more detailed statutory prospectus.

should include brief information regarding investment advisers and portfolio managers, purchase and sale procedures, tax consequences and financial intermediary compensation.

Mutual funds may opt to use the summary prospectus provided that the mutual fund's summary prospectus, statutory prospectus, and other specified information are available online or sent in hardcopy to investors upon request. The summary prospectus must contain the same information in the same order as the summary section at the front of the statutory prospectus.

To date, the SEC has not published the final rule release, but has communicated the following information regarding the amendments:

- The online materials must be in a user-friendly format that permits investors and other users to move back and forth between the summary prospectus and the statutory prospectus.
- Investors must be able to download and retain an electronic version of the information.
- The statutory prospectus and other information must be provided in paper or by e-mail upon request so that investors can choose the format in which they receive more detailed information.

The adopted rule amendments will contain some differences from the proposed rules. Among the changes:

- Funds opting to use a summary prospectus will not be required to update it quarterly, as was initially proposed. Instead, the summary prospectus will be updated annually and will contain a legend directing investors to more recent information.
- The summary prospectus will not include the fund's top 10 portfolio holdings.
- A summary prospectus may not contain information on multiple funds, but the summary section of a multi-fund statutory prospectus can combine information that is identical for all of the included funds.

The rule amendments will become effective on February 28, 2009, and funds may begin using the summary prospectus on that date. Funds will be required to include the summary section in the statutory prospectus on January 1, 2010.

SEC Adopts XBRL Requirement

The SEC recently approved two rules requiring mutual funds and public companies to use eXtensible Business Reporting Language (XBRL) in regulatory filings. On December 17, 2008, the SEC adopted an amendment that will require mutual funds to provide the risk/return summary section of their prospectuses in interactive data format using XBRL. Beginning January 1, 2011, funds must file XBRL-tagged risk/return summaries with the SEC for all new funds and post-effective amendments, as well as post the data on their websites. The January 2011 deadline is a year later than the SEC originally proposed. Also adopted on December 17, an additional amendment will require all public companies

to provide financial statement information in XBRL. For these companies, XBRL financial reporting will occur on a phased-in schedule beginning in 2009. Approximately 500 companies who file using U.S. Generally Accepted Accounting Principles (GAAP) with a public float of more than $5 billion will be required to provide interactive data reports starting with their first quarterly report for fiscal periods ending on or after June 15, 2009. Other remaining domestic and foreign large accelerated filers using U.S. GAAP will be required to file in 2010 and all other filers in 2011. Companies reporting in International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board will be required to provide their interactive data reports starting with fiscal years ending on or after June 15, 2011. All XBRL tagged documents will be included as exhibits to EDGAR-based SEC filings.

The XBRL mandate is intended not only to make financial statement and risk/return summary information easier for investors to analyze, but also to assist in automating regulatory filings and business information processing.

According to the SEC, interactive data will increase the speed, accuracy, and usability of mutual fund disclosure, and ideally reduce costs. Using XBRL, all of the facts in a financial statement or risk/return summary are labeled with unique computer-readable "tags." These tags operate like bar codes, making financial information searchable on the Internet and readable by spreadsheets and other software. XBRL-tagged data can be downloaded directly into spreadsheets and analyzed in a variety of ways using commercial off-the-shelf applications. Investors will be able to locate specific information disclosed by companies and mutual funds, and compare that information with other companies and mutual funds to help them make investment decisions.

In a related move earlier this year, the SEC introduced its new financial reporting system IDEA (Interactive Data Electronic Applications). The new IDEA system is currently supplementing, and will eventually replace, the agency's EDGAR database. IDEA is specifically designed to accept XBRL filings and will allow investors easier access to financial information about public companies and mutual funds. As companies and funds begin to comply with the XBRL filing requirement, their financial information will be available on the IDEA system. Data submissions for participants in the SEC's voluntary program are currently available at http://idea.sec.gov.

Similar to the voluntary program, mandatory XBRL submissions will be subject to limited liability. However, unlike the proposed amendment, the final rule phases out limited liability over a two-year period. Consistent with the proposed amendment, the final rule will not require tagging of narrative disclosures, although such tagging is permitted. Finally, XBRL files will be exempt from the officer certifications of the Securities and Exchange Act of 1934 (1934 Act) and will not require issuers to obtain auditor assurance. The final rule releases have not yet been published.

SEC Approves Credit-Rating Agency Rules

On December 3, 2008, the SEC approved a series of rule amendments and proposed others designed to increase transparency and accountability and to mitigate conflicts of interest at credit rating agencies.

The SEC adopted three amendments to Rule 17g-5(c) of the 1934 Act. Rule 17g-5 requires a Nationally Recognized Statistical Ratings Organization (NRSRO) to disclose certain conflicts of interest and prohibits others. The amendments add three new prohibited conflicts of interest to Rule 17g-5(c). Under the new rules, an NRSRO is prohibited from issuing a credit rating regarding a security if the NRSRO or an affiliate took part in structuring the security. The second amendment prohibits NRSRO personnel who have responsibility for determining credit ratings or developing or approving ratings procedures or methodologies from participating in any fee discussions, negotiations, or arrangements. Third, an NRSRO is prohibited from allowing a credit analyst who

The Commission declined to vote at the December 3, 2008, meeting on several widely debated reforms aimed at reducing money market funds reliance on credit ratings.

participated in a rating to receive gifts from the issuer, underwriter or sponsor of the securities being rated that have an aggregate value of more than $25.

The SEC also adopted amendments requiring NRSROs to provide more disclosure concerning their ratings. The amendments add three new recordkeeping requirements to Rule 17g-2 of the 1934 Act. The first amendment requires an NRSRO to make and retain records of all rating actions related to a current rating from the initial rating through the current rating. The second new amendment requires an NRSRO to record the rationale for any material difference between the rating implied by a quantitative model and the final credit rating issued for structured finance products. The third new recordkeeping requirement requires that an NRSRO retain records of any complaints regarding the performance of a credit analyst regarding the assignment of a credit rating.

Additionally, an amendment to Rule 17g-3 requires an NRSRO to provide the SEC with an annual report of the credit rating actions that occurred during the fiscal year for each class of security for which the NRSRO is registered.

Finally, the SEC re-proposed an amendment to Rule 17g-5 prohibiting an NRSRO from issuing a rating for a structured finance product paid for by the product's issuer, sponsor, or underwriter unless the NRSRO makes information about the product used to determine the rating available to other NRSROs.

"Red Flags" Deadline Extended to May 1, 2009

On July 17, 2008, the Investment Company Institute (ICI) issued an Urgent Memorandum to investment companies that hold "transaction accounts" under Section 19(b) of the Federal Reserve Act. The ICI release stated that the SEC had recently confirmed that investment companies with transaction accounts would be required to implement an identity theft prevention program in compliance with the Federal Trade Commission's "red flags rules" by November 1, 2008. However, the Federal Trade Commission (FTC) decided to delay enforcement until May 2009, stating that many entities had learned of the rule's requirements too late to be able to comply by the November 1 deadline. Since mutual funds generally are not required to comply with FTC rules, it was previously thought that the "red flags rules", issued in November 2007 in order to implement certain sections of the Fair and Accurate Credit Transactions Act of 2003, did not apply to them.

Funds subject to the "red flags rules" are required to establish and implement a program to detect, prevent and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The program must include reasonable policies and procedures to identify, detect and respond to red flags, or to those patterns, practices, or specific activities that indicate the possible existence of identity theft. The program must be approved by the funds' boards of directors and be updated periodically to reflect any changes in identity theft risk.

Plaintiffs Petition Supreme Court in Jones v. Harris Associates

On November 3, 2008, plaintiffs in the case of Jones v. Harris Associates (7th Circuit May 19, 2008) filed for review before the U.S. Supreme Court. The U.S. Court of Appeals for the Seventh Circuit rejected the plaintiffs' allegation of excessive advisory fees and ruled that a fund adviser's compensation is not subject to judicial review for reasonableness when there has been full disclosure of the fees and approval by the fund's trustees. That decision rejected the standard set by the Second Circuit in Gartenberg v.

Merrill Lynch Asset Management, (2nd Cir. 1982). The court in Gartenberg held that when determining whether a fund adviser has breached its fiduciary duty by charging excessive fees, the test is whether the advisory fee represents a charge so disproportionately large that it bares no reasonable relationship to the services rendered and could not have been negotiated at arm's length. A previous motion by plaintiffs for rehearing en banc (with all judges present and participating) was denied by the Seventh Circuit in a 5-5 split, although Judge Posner wrote a strong dissent from the decision.

Since the Jones decision is binding only in Illinois, Indiana and Wisconsin, the case creates a split in the circuits, a classic reason for the Supreme Court to accept a case for review. At this time, it is not known whether the Supreme Court will accept the case, however, as the Court often will wait to allow other circuits to weigh in and resolve a circuit split before it puts the case on its docket.

First Circuit Decides SEC v. Tambone

The District Court previously dismissed the SEC's charge that the defendants were primary violators of federal securities laws because the defendants had not personally drafted any prospectus they distributed.

On December 3, 2008, the First Circuit announced its decision in SEC v. Tambone (1st Circuit Dec. 3, 2008). The First Circuit held that senior executives of the primary underwriter of a fund can be held liable for disseminating a prospectus that contains materially untrue statements. In this case, the defendants had allegedly made arrangements that allowed certain investors to execute "round-trip" trades in exchange for long-term investments in other funds, although they knew the prospectus contained language strictly prohibiting market timing of any kind.

The First Circuit reversed the District Court's decision, citing broad language under Section 10(b) of the 1934 Act that makes it unlawful to "use or employ" any deceptive device in connection with the purchase or sale of securities. The First Circuit concluded, therefore, that the defendants had "made" "implied" misstatements under Rule 10b-5 and could be held liable as "primary" actors. Before the Tambone decision, it was thought that such executives could only be held liable as "secondary" actors. Since only the SEC can bring an "aiding and abetting" claim, private plaintiffs were previously prevented from bringing suits against secondary actors. The Tambone decision ostensibly opens the door for private plaintiffs' actions against secondary actors.

The court also found the defendants liable under Section 17(a)(2) of the 1933 Act. The court stated that liability may attach under Section 17(a)(2) if a defendant has obtained money by means of any untrue statement of a material fact, even if the defendant has not "made" the statement under the meaning of Rule 10b-5. Furthermore, Section 17(a) does not require proof of a culpable state of mind, unlike Rule 10b-5, which requires that the defendant act with intent, knowledge or a high degree of recklessness. Merely negligent conduct is sufficient under 17(a), and combined with the wide range of conduct the section prohibits, the Tambone decision confirms 17(a)(2) is broader than Rule 10b-5. In essence, Tambone authorizes primary liability under Section 17(a) for officers and employees of underwriters and broker-dealers for "using" an issuer's prospectus they either knew or should have known contained misrepresentations.

It is unknown whether the defendants will seek a reconsideration en banc.

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