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Investment Management Update

August 2009

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SEC Charges Reserve Primary Fund Operators with Fraud

The SEC brought an action against Reserve Management Company, Inc. (RMCI), Bruce Bent Sr., the founder of RMCI, and his son Bruce Bent II for securities fraud. The SEC alleges that RMCI and each Mr. Bent **"engaged in a systematic campaign to deceive the investing public"** when the Primary Reserve Fund, advised by RMCI, "broke the buck" in September 2008. **The SEC's complaint follows on the heels of approximately twenty nine other lawsuits filed in connection with this matter**. According to the SEC, "the resolution of those suits may lead to conflicting judicial determinations and inconsistent treatment of shareholders, as well as an inexorable and piecemeal drain on the Fund's assets." To address this possibility, the **SEC seeks, in part, "to compel the distribution of all remaining Fund assets on a *pro rata* basis."**

Background

On September 15, 2008, Lehman Brothers filed for bankruptcy protection. According to the SEC's complaint, at that time the Fund "held $785 million in Lehman-issued securities." The SEC alleges that after Lehman's filing, RMCI, the Fund's adviser, **"was immediately besieged by shareholders seeking to redeem their shares** based on fears that a decline in the value in the Fund's Lehman holdings could compromise the Fund's $1.00 NAV." According to the SEC, the **"decline in value in the Fund's Lehman holdings," coupled with the fact "that there was 'no valid market' for Lehman paper," caused the Fund to break the buck on September 16**.

Allegations

The SEC alleges that, before the Fund broke the buck, **"in order to persuade investors to refrain from redeeming shares, and to induce new purchases of shares, [the defendants] systematically violated the antifraud provisions of the federal securities laws by, *inter alia,* misrepresenting material facts concerning the [Fund's] status,** most notably by falsely assuring shareholders, the Fund's Board of Trustees and the rating agencies that RMCI had agreed to provide the Fund with sufficient capital to maintain its NAV at $1.00." The complaint states that the defendants had no intention of supplying the capital and that their **"decision to announce unqualified financial support for the Primary Fund was driven by a desire to falsely reassure shareholders that the Fund remained safe,** thus slowing the rate of redemptions, and a desire to placate Moody's and Standard & Poor's, thus avoiding a calamitous ratings downgrade."

According to the complaint, the defendants' "misconduct on September 15 and 16 arose from a simple reality: unless RMCI could persuade shareholders that the $1.00 NAV of the Fund was absolutely safe despite the Fund's Lehman

exposure, shareholders would continue to redeem shares in massive and unsustainable amounts."

The complaint **"seeks a final judgment permanently enjoining the defendants from future violations** of the federal securities laws and **ordering them to pay civil penalities and disgorgement of ill-gotten gains** plus prejudgment interest." To effect the release of approximately $3.5 billion "that is currently being withheld from investors pending the outcome of numerous lawsuits against the [F]und," the SEC also seeks to compel the Fund **"to distribute all [Fund] assets *pro rata* for all redeemed shares for which shareholders have not been fully paid or to entertain any suitable application or motion for additional relief."**

SEC Disapproves of 15(c) Process

In a rare settlement order involving an alleged violation of Section 15(c) of the Investment Company Act, **the SEC charged an investment adviser with "failing to provide information necessary for the [fund] [b]oard to evaluate" adequately the investment advisory contract.** As part of its settlement with the SEC, the adviser agreed to pay more than $6 million in disgorgement, prejudgment interest and penalties.

Background

According to the settlement order:

- One of the funds overseen by the board was **offered with an "unconditional guarantee" that, generally, would protect a shareholder's investment** in the fund in connection with a market down-turn.
- Until 2004, the fund stated in "every prospectus, registration statement and annual report . . . that **'[t]here is no charge to the [f]und or its shareholders for the [g]uarantee program**.'"
- From 2000 through 2003, **the board was "presented with information showing that the . . . [f]und's management fees were the highest in its peer-group."**
- From 2000 to 2003, the **adviser did not give the board "the estimated financial cost or value of the [g]uarantee,"** but the adviser "urged the [b]oard to consider the [g]uarantee in evaluating the management fees . . .."
- "During the spring of 2001, in light of changing market conditions, [the adviser] . . . began to analyze the financial exposure of providing the [g]uarantee . . .. **On January 14, 2002 . . . [the adviser] established for the first time a reserve of $2 million related to the [g]uarantee . . . and . . . [i]n January 2003, [the adviser] recorded a reserve of $11.9 million . . .."** According to the SEC, the establishment of the reserve was not explicitly disclosed to the board in 2002, though it was reflected in the adviser's profitability calculations.
- In 2003, an independent consultant reviewed the fund's management fees and "concluded . . . the [g]uarantee, although 'unique,' was 'of somewhat limited value.'" That same consultant concluded that **"[h]igh expenses are the main reason this fund ranks worst among its index-fund peers for the one-, three-, and five-year periods,"** exacerbated by "a management fee that is more than twice the peer-group average."
- At the annual contract renewal meetings held on June 14 and 15, 2004, the adviser "provided the [b]oard with information concerning the assumptions used to calculate the reserve . . .." Also, while "[the adviser] continued to assert . . . that the [g]uarantee . . . justified the higher fees . . . **during the same meetings, [the adviser] provided other materials to the [b]oard stating that the [g]uarantee was provided to the shareholders at 'no cost.'"**
- On June 30, 2004, **the adviser "amended the prospectus . . . to inform investors for the first time that the [g]uarantee was taken**

into account in setting the management fees . . ..”

- “In July 2004, as part of the contract renewal approval process, **the [b]oard voted to lower the management fee . . .** from 50 basis points to 30 basis points and to cap the [fund’s] expense ratio at 80 basis points.”

Alleged Violations

According to the SEC, the adviser:

- **Provided insufficient 15(c) disclosures to the board:** “During the 2002 and 2003 15(c) processes **[the adviser] explained the fee being sought by reference to the [g]uarantee feature of the [f]und while failing to provide information necessary for the [b]oard to evaluate the [g]uarantee’s true cost or value.** Prior to the 2004 [b]oard meeting, [the adviser] did not provide the [b]oard with information concerning the assumptions used to calculate the reserve . . ..”
- **Made misleading filings: The adviser filed “annual reports to shareholders, registration statements, and prospectuses with the [SEC] in which it stated that there was no charge** to the [f]und or its shareholders for the [g]uarantee.”

SEC Criticized Fund’s Fair Valuations

The SEC recently published a settlement order in which it **found that a fund manager’s valuation of certain securities caused one of the funds advised by the manager to “overstate its per share net asset value (NAV) by as much as 17%” over a period of about 16 months. The SEC also alleged that the manager engaged in selective disclosure to at least one of its clients of the “re-pricing” of a number of portfolio holdings** such that the NAV of the fund would decline. The SEC alleges that, as a result of this disclosure, the client “promptly sold its position in the . . . [f]und.” Finally, in its settlement order, the SEC also found certain violations related to transactions among funds in the same family and certain requirements related to the retention of records. The adviser and its affiliates agreed to pay $33 million in compensation to Fund shareholders, $4 million in penalties and $3 million in disgorgement of earned fees.

Background

According to the SEC, the fund’s investments consisted “primarily [of] residential mortgage-backed securities and collateralized debt obligations” and “there was no market price readily available for many of the [f]und’s holdings.” The SEC alleged that during its fair valuation of these securities, **the fund (through its manager) “failed to take into account in its valuation of certain . . . securities readily-available negative information** concerning the value of those holdings.” For example, the SEC noted that the fund did not consider media reports that “due to rising mortgage defaults and delinquencies, an index that served as a benchmark measure of the riskiness of residential mortgage-backed securities had substantially weakened . . .. In addition, on multiple occasions, the [f]und’s portfolio management team did not properly factor readily-available data showing an increase in the default or delinquency rate for the subprime residential mortgages backing a collateralized debt obligation security (CDO) owned by the [f]und into the security’s valuation.” **According to the SEC, this resulted in an overstatement of the fund’s NAV from February 2007 to June 2008.**

The SEC also criticized the manager for periodically valuing securities using “an individual broker-dealer located in Florida, whose method for determining prices it had not reviewed or approved.” According to the SEC, “far less due diligence was being conducted on the Florida broker-dealer than was being conducted on other pricing sources. Fifteen of the sixteen securities valued based on prices provided by the Florida broker-dealer were re-priced downward in June 2008, eight by more than 90%.”

Among **other allegations** the settlement order included that:

- **the fund's portfolio management team "with[held] relevant negative information about one or more of the [f]und's fair valued securities from the [manager's] Valuation Committee."** For example, "the portfolio manager team learned . . . that [a] tranche of [a] CDO owned by the [f]und would not receive any more cash flow until the senior tranche had been repaid in full . . .. The [f]und's portfolio management team failed to disclose this to the Valuation Committee."
- **the portfolio management withheld from the manager's valuation committee information about the purchase price of a security, which the fund was carrying at more than ten times the value at which that security had recently been sold.** According to the SEC, the portfolio management team learned that another fund in the complex purchased one of the securities in question at a significantly lower price than that at which their own fund was carrying the security. Upon learning of this purchase, the "portfolio management team contacted the selling broker-dealer to determine whether the sale was 'distressed' (and thus could potentially be disregarded for purposes of determining the fair value of the security)." The broker-dealer responded that the sale was not "distressed," yet **"the portfolio management team informed the Valuation Committee that they believed the sale was distressed and did not disclose the broker-dealer's statement to the Valuation Committee."**
- **the fund's distributor engaged in selective disclosure of material, non-public information. Specifically, the SEC states that the distributor prepared "talking points" of information to be shared with investors who might call to inquire about the fund's NAV decrease** once a number of the fund's holdings were re-priced downward (which occurred "due, in part, to growing concerns about the accuracy of valuations provided by the [f]und's portfolio management team"). According to the SEC, **the talking points were "material information" that was never publicly disseminated (through a press release or otherwise)** and thus disclosing that information selectively constituted dissemination of material, non-public information.

Violations

The violations of law cited in the settlement order included that the manager **"willfully . . . engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon clients or prospective clients." Also, the SEC found that "neither the [adviser] nor the [distributor] established, maintained, or enforced written policies and procedures reasonably designed to prevent this type of misuse of material, non-public information** by persons associated with them – i.e., the disclosure of material, non-public information about a fund they advised or distributed to select shareholders."

SEC Proposes New Disclosure Regarding Fund Governance

The SEC has proposed rule amendments that would supplement the disclosure corporate registrants, including mutual funds and closed-end funds, are currently required to make about their boards of directors. **The SEC's proposals would amend existing proxy solicitation and registration statement rules to require that, among other things, additional information about incumbent directors and board nominees be disclosed, as well as facts relating to the board and its role in the overall risk management process.** The proposal comes at the end of what the SEC describes as an 18-month period of "turmoil," and represents **an effort to enhance transparency, "especially with regard**

to activities that materially contribute to a company's risk profile."

Director and Nominee Disclosure

As described in its July 10, 2009 rule proposal, the SEC would amend the proxy rules so that in proxy solicitations where action is to be taken with respect to the election of directors, a discussion must be provided **"detailing for each director and nominee for director the particular experience, qualifications, attributes or skills that qualify that person to serve as a director of the [fund] . . . and as a member of any committee that the person serves on or is chose to serve on (if known), in light of the [fund's] business and structure."** These revisions, the SEC explains, "are aimed at helping investors determine whether a particular director and the entire board composition is an appropriate choice."

The SEC also proposes to revise proxy statement rules to require disclosure of (i) public company directorships held by each director and nominee at any time during the past five years and (ii) legal proceedings involving each director or nominee during the past ten years. Furthermore, the SEC would amend mutual fund and closed-end fund registration forms **"to require that funds include the expanded disclosures regarding director qualifications and past directorships in their statements of additional information."**

The SEC seeks comments on these proposals, specifically whether director qualification disclosure should be focused on key board committees, "such as the audit, compensation and nominating/governance committees," and whether the amendments should even apply to mutual funds and closed-end funds.

The Board's Risk Management Role

"Given the role that risk and the adequacy of risk oversight have played in the recent market crisis," the SEC explains, "we believe it is important for investors to understand the board's . . . role in this area." For example, the SEC asks, does the board implement and manage its risk management function "through the board as a whole or through a committee, such as an audit committee?" Accordingly, the rule proposal includes revisions to proxy statement rules that **would require disclosure "about leadership structure and the board's role in the risk management process." A fund would also be required to disclose in its proxy statements whether the chairman of its board was an "interested person" as defined by the Investment Company Act of 1940, and if so, whether the board had any "lead independent director and what specific role the lead independent director plays in the leadership of the fund."**

The SEC proposes that similar disclosure regarding fund boards' risk management function be incorporated into Form N-1A, N-2 and N-3 statement of additional information disclosure requirements.

The SEC seeks comment on, among other things, whether: these requirements should apply to mutual fund and closed-end funds; there should be disclosure differentiations between mutual funds and closed-end funds; and alternative disclosures relating to "board involvement in the risk management process [might] be more helpful to investors."

The full text of the proposing release, SEC Release No. 33-9052 (June 10, 2009), can be found on the SEC's website at http://www.sec.gov/rules/ proposed/2009/33-9052.pdf.

Comments on the rule proposal are due to the SEC on or before September 15, 2009.

SEC Proposes Changes to Director Nomination Procedures

On June 10 the SEC issued a release proposing changes to the federal proxy rules "to remove impediments to the exercise of shareholders' rights to nominate and elect directors to company boards of directors." The SEC proposed:

- a new rule that would require a company, including an investment company, to include shareholder nominees for director in the company's proxy materials in certain circumstances; and
- to amend an existing rule to generally prohibit a company from excluding proposals that would amend a company's nomination procedures or disclosures related to shareholder nominations from the company's proxy materials.

Overview of Proposed Rule 14a-11

Any company, including an investment company, that is subject to the SEC's proxy rules would be required to comply with new Rule 14a-11, except when the company's governing documents or applicable state law preclude shareholders from nominating directors. The proposed rule seeks to "balance shareholders' ability to participate more fully in the nomination and election process against the potential cost and disruption to companies subject to the proposed rule." Accordingly, a company would be required to include the nominees only of shareholders who meet proposed eligibility and other conditions of the rule.

Shareholder eligibility requirements. "Only shareholders of a significant, long-term interest in a company" could rely on the Rule. Thus, to have nominees included in a company's proxy materials, a shareholder or group of shareholders would have to meet certain minimum ownership thresholds and other requirements. The ownership thresholds would vary depending on the size of the company. For **registered investment companies with net assets of $700 million or more** and large accelerated filers, the nominating shareholder or group would have to beneficially own, either individually or in the aggregate, **at least 1%** of the company's securities entitled to vote on the election of directors at the shareholder meeting. For smaller investment companies, the required threshold would be 3% or 5% depending on certain other factors.

Unless they have reason to know that the information is inaccurate, shareholders of an investment company could rely on the information in the following documents to determine the applicable ownership threshold:

- For **a non-series investment company**, the most recent annual or semi-annual report filed with the SEC on **Form N-CSR** (net assets would be the net assets as of the end of the second fiscal quarter in the fiscal year immediately preceding the fiscal year of the meeting); and
- For **a series investment company**, **a Form 8-K that such company would be required to file with the SEC** disclosing for the company as a whole, and not on a series by series basis, (i) the company's net assets as of June 30 of the calendar year immediately preceding the calendar year of the meeting and (ii) the total number of shares outstanding and entitled to be voted at a shareholder meeting as of the end of the most recent calendar quarter (or if the votes are to be cast on other than a one vote per share basis, the total number of votes entitled to be voted and the basis for allocating such votes).

In addition to the minimum ownership thresholds, nominating shareholders must also:

- have beneficially owned the securities used in the calculation of the ownership threshold continuously for at least one year (for a shareholder group, each member of the group would be required to meet this requirement);
- represent that they intend to continue to own the securities through the date of the meeting; and

- hold the securities for a purpose other than effecting a change of control or gaining more than a limited number of seats on the board.

Shareholder nominee requirements and limitations. As proposed, the new rule would place certain limitations on the shareholder nominees required to be included in a company's proxy materials. For example, a nominating shareholder of a registered investment company would need to represent that its nominee is not an "interested person" of the company, as defined in the Investment Company Act of 1940.

Procedural Requirements. Under proposed Rule 14a-11, there are a number of procedural elements that both a nominating shareholder and a company would have to meet. Generally, a shareholder would have to provide a notice of its intent to include a nominee in the company's proxy materials to the company and file the notice with the SEC on proposed new Schedule 14N within a certain time period. The company would then be required to notify the shareholder if it determines it may exclude the nominee and the shareholder would be given an opportunity to respond. Both the company and the shareholder may have additional notice requirements depending on various factors.

Overview of Proposed Amendments to Rule 14a-8

Rule 14a-8 currently allows a company to exclude a shareholder proposal that "relates to a nomination or an election for membership on the company's board of directors or analogous governing body or a procedure for such nomination or election" from its proxy statement. As proposed, the amendment to Rule 14a-8(i)(8) would allow a shareholder to require that a company include in its proxy materials a proposal to amend, or that requests an amendment to, the governing documents of the company regarding nomination procedures or disclosures related to shareholder nominations in certain cases if the proposal would not conflict with proposed Rule 14a-11 or applicable state law.

Eligibility Requirements. Shareholders desiring to include a proposal in a company's proxy materials in reliance on this Rule would have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to vote on the proposal at the meeting for a period of at least one year before submitting the proposal. The shareholder proposal could not be subject to any of the other substantive exclusions under Rule 14a-8 and would have to meet the procedural requirements of Rule 14a-8.

The SEC also made a number of smaller, accompanying proposals, which are related to the two main proposals summarized above. Comments must be submitted to the SEC by August 17, 2009.

The full text of the proposing release, SEC Release No. 33-9046 (June 10, 2009), can be found on the SEC's website at http://www.sec.gov/rules/proposed/2009/33-9046.pdf.

SEC Proposes New Rules for Money Market Funds

The SEC recently proposed amendments to certain rules that govern money market funds. The SEC stated in the proposing release that **the amendments are "designed to make money market funds more resilient to certain short-term market risks, and to provide greater protections for investors in a money market fund that is unable to maintain a stable net asset value per share."** The SEC's proposal largely tracks the principles of the recommendations made by the ICI Money Market Working Group, as discussed in the May edition of the newsletter.

The proposed amendments would, among other things:

- require that money market funds have certain minimum percentages of their assets in cash or securities that can be readily converted to cash, to pay redeeming investors;

- shorten the weighted average maturity limits for money market fund portfolios from 90 days to 60 days;
- eliminate a fund's ability to invest up to 5% of its assets in lower quality, "second tier" securities;
- **require money market fund boards to adopt procedures for periodic stress testing** of a fund's ability to maintain a stable net asset value per share based upon certain hypothetical events;
- require money market funds to report their portfolio holdings monthly to the SEC and post them on their websites;
- require that funds have the operational capacity to "break the buck" and continue to process investor transactions in an orderly manner; and
- permit a money market fund that has "broken the buck" to suspend redemptions to allow for the orderly liquidation of fund assets.

In addition, the SEC is seeking comment on other potential changes in its regulation of money market funds, including whether money market funds should, like other types of mutual funds, have "floating" rather than stabilized net asset values. In a statement at the SEC Open Meeting on Money Market Reform, SEC Chair Mary Schapiro said, **"I will be very interested in commenter views on whether a so-called 'floating net asset value' would better protect investors from runs on money market funds and other abuses**, or whether the efficiency of the $1.00 net asset value is more beneficial to investors."

The SEC is also seeking comment on whether to eliminate references to credit rating agencies in the money market fund rule and **whether fund boards should designate three or more rating agencies that the fund would look to for all purposes under the rule in determining whether a security is an eligible security.**

The comment period for the proposal ends on September 8, 2009.

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