FUND ALERT

A Stradley Ronon Investment Management Group Bulletin

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Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103
215.564.8000 Telephone
215.564.8120 Facsimile
www.stradley.com

1220 19th Street NW, Suite 600
Washington, DC 20036
202.822.9611 Telephone
202.822.0140 Facsimile

With other offices in:
Harrisburg, Pa.
Malvern, Pa.
Wilmington, Del.
Cherry Hill, N.J.

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Crisis on Wall Street – What Now?

Recent developments in the financial markets have led to tremendous turmoil in the financial industry. In recent days, we have seen the merger of two large broker-dealers, the federal government's takeover of Freddie Mac and Fannie Mae, the acquisition of one of the world's largest brokerage houses by a consumer bank and yet another Fed bailout of one of the largest insurance companies. In addition, at least one money market fund has fallen below $1 per share in net asset value due to significant losses on debt issued by a troubled financial institution. The implications of these events on the fund industry are still evolving. Funds and their investment advisers will face difficult decisions as they seek to respond to the financial crisis and protect shareholder assets. This *Fund Alert* identifies some of the common issues that funds and their investment advisers will face in the wake of the recent market turmoil.

Money Market Funds. In order to maintain a constant share value, most money market funds use the "amortized cost" method of valuation. Under this method securities are valued at acquisition cost rather than market value, and interest earned on each security (plus any discount received or less any premium paid upon purchase) is accrued uniformly over the remaining maturity of the purchase. By declaring these accruals as a daily dividend to its shareholders, the fund is able to maintain a stable price of $1 per share. Money market funds should evaluate their holdings to determine if they can continue to utilize the "amortized cost" method of valuation if their holdings include securities of troubled financial institutions. Money market funds that hold troubled securities have, more often than not, received assistance from their affiliates in order to maintain their $1 per share price. The SEC Staff has been very willing and available to assist such funds with the necessary regulatory relief.

Valuation. Aside from the immediate impact of recent declines in securities prices to the value of fund holdings, funds must determine the appropriateness of their valuations of troubled financial institutions as market valuations of such institutions become more questionable in the face of rapidly changing circumstances.

Risk Assessment. Investments in derivative instruments involve

counterparty risk. In light of recent market events, financial institutions that act as counterparties may face insolvency or otherwise risk defaulting on their obligations. Investment advisers are identifying the exposure of their funds to troubled issuers and counterparties and reporting the extent of such exposure to fund boards.

Shareholder Communications. As the value and risks of portfolio holdings change over time, funds should continue to evaluate whether prospectus and other shareholder communications accurately reflect evolving investment positions. Funds and their advisers will need to ensure that shareholder communications remain accurate in a rapidly changing marketplace.

Disclosure of Portfolio Holdings. Institutional and other investors seeking to manage their investments, as well as various financial intermediaries, may inquire about fund holdings of troubled financial institutions. In responding to such inquiries, funds must comply with their portfolio holdings disclosure policies.

Investments in Securities Related Businesses. Section 12(d)(3) of the Investment Company Act makes it unlawful for funds to acquire any security issued by, or any interest in the business of, any broker-dealer, any person engaged in the business of underwriting, or an investment adviser of an investment company, or a registered investment adviser. However, Rule 12d3-1 under the Investment Company Act provides an exemption from the prohibition of Section 12(d)(3) for acquisitions of certain securities. In light of increasing mergers and buyouts of troubled financial firms, funds investing in securities-related businesses should evaluate whether their investments in securities-related businesses continue to be exempt pursuant to Rule 12d3-1.

Securities Lending. Funds that have lent portfolio securities to troubled broker-dealers and other financial firms should consider whether to recall such securities. Funds may also reassess the value of collateral involving securities of such broker-dealers and financial firms to ensure sufficient coverage for loaned securities.

ISDA Issues. Funds and investment advisers should consider whether the bankruptcy of a counterparty or a Credit Support Provider to an ISDA Master Agreement has resulted in an Event of Default or other Termination Event. Even if the agreement is not in default, ratings downgrades may occur and further monitoring may be necessary to determine whether a right to early termination has been triggered. Failure of a counterparty to make a payment or transfer collateral in accordance with the terms of their Credit Support Agreement would also give rise to an Event of Default. If Automatic Early Termination for Bankruptcy has been designated, the agreement terminates as of the date of the bankruptcy filing.

We have received inquiries regarding the implication of these recent market events for funds and their investment advisers. Accordingly, we have established teams of Stradley attorneys to respond to such inquiries. The teams and their contact information are provided on the next page. ■

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Stradley Ronon's Investment Management Group

Attorneys:

Bruce G. Leto, Chair .....bleto@stradley.com.....215.564.8115
John N. Ake .....jake@stradley.com 215.564.8003
John M. Baker .....jbaker@stradley.com.....202.419.8413
Fabio Battaglia III .....fbattaglia@stradley.com 215.564.8077
E. Carolan Berkley .....ecberkley@stradley.com.....215.564.8018
Emily Taylor Brody .....ebrody@stradley.com 215.564.8071
Jana L. Cresswell.....jcresswell@stradley.com.....215.564.8048
Matthew R. DiClemente .....mdiclemente@stradley.com 215.564.8173
Lisa A. Duda .....lduda@stradley.com 215.564.8143
J. Stephen Feinour .....jfeinourjr@stradley.com 215.564.8521
Amy C. Fitzsimmons .....afitzsimmons@stradley.com....215.564.8711
Alison M. Fuller .....afuller@stradley.com 202.419.8412
Robert K. Fulton .....rfulton@stradley.com 215.564.8042
Alan R. Gedrich.....agedrich@stradley.com.....215.564.8050
Samuel K. Goldstein .....sgoldstein@stradley.com 215.564.8128
Kenneth L. Greenberg .....kgreenberg@stradley.com....215.564.8149
Cory Owen Hippler .....chippler@stradley.com 215.564.8089
Peter M. Hong .....phong@stradley.com.....202.419.8429
Kristin H. Ives .....kives@stradley.com 215.564.8037
Lisa M. King .....lking@stradley.com 215.564.8733
Jonathan M. Kopcsik .....jkopcsik@stradley.com.....215.564.8099
Nicolas Lombo* .....nlombo@stradley.com 215.564.8553
Cillian M. Lynch .....clynch@stradley.com 202.419.8416
Michael D. Mabry .....mmabry@stradley.com 215.564.8011
Gino E. Malaspina* .....gmalaspina@stradley.com ..215.564.8080
Katherine R. Mason.....kmason@stradley.com 215.564.8006
Prufesh R. Modhera.....pmodhera@stradley.com.....202.419.8417
Barbara A. Nugent .....bnugent@stradley.com 215.564.8092
Aidan H. O'Connor .....aoconnor@stradley.com 202.419.8406
James J. O'Connor.....joconnor@stradley.com 215.564.8139
Michael P. O'Hare .....mohare@stradley.com.....215.564.8198
William H. Rheiner .....wrheiner@stradley.com 215.564.8082
Mena M. Ryley .....mryley@stradley.com 215.564.8014
Mark A. Sheehan .....msheehan@stradley.com.....215.564.8027
Alexander F. Smith* .....asmith2@stradley.com 215.564.8554
Amy G. Smith .....asmith@stradley.com 215.564.8104
Lawrence P. Stadulis .....lstadulis@stradley.com 202.419.8407
Merrill R. Steiner.....msteiner@stradley.com.....215.564.8039
Joan Ohlbaum Swirsky .....jswirsky@stradley.com.....215.564.8015
Angela R. Thompson.....athompson@stradley.com 202.419.8409
Christopher J. Zimmerman ....czimmerman@stradley.com 202.419.8402

Practice Group Administrator:

Sinclair A. Ziesing .....sziesing@stradley.com 215.564.8055

Legal Assistants:

Robert Davis .....rdavis@stradley.com.....215.564.8768
Dawn E. Mac Donald .....dmacdonald@stradley.com ..408.241.1770
Staci J. Pesin .....spesin@stradley.com.....215.564.8710
Kristopher R. Pietrzykowski ....kpietrzykowski@stradley.com..215.564.8114
Bonnie M. Scott.....bscott@stradley.com.....215.564.8727
Theresa West .....twest@stradley.com 202.419.8411

**Pending Bar results*

Fund Taxation

Attorneys:

Zachary P. Alexander.....zalexander@stradley.com 215.564.8043
Kristin M. McKenna .....kmckenna@stradley.com 215.564.8176
William S. Pilling III .....wpilling@stradley.com 215.564.8079
Christopher C. Scarpa .....cscarpa@stradley.com.....484.323.1356

Fund Enforcement and Litigation

Attorneys:

Sean R. Adam .....sadam@stradley.com 215.564.8094
Steven B. Davis .....sdavis@stradley.com.....215.564.8714
Gregory D. DiMeglio .....gdimeglio@stradley.com 202.419.8401
Keith R. Dutill .....kdutill@stradley.com 610.640.5809
Thomas W. Dymek .....tdymek@stradley.com.....215.564.8053
Zachary T. Knepper .....zknepper@stradley.com 202.419.8414
David C. Franceski Jr. .....dfranceski@stradley.com 215.564.8062
Margaret Manolakis .....mmanolakis@stradley.com 610.640.5801
Paula D. Shaffner.....pshaffner@stradley.com 215.564.8761
Rachel Tausend .....rtausend@stradley.com.....202.419.8405

ERISA

Attorneys:

John J. Hunter .....jhunter@stradley.com 215.564.8072
James F. Podheiser.....jpodheiser@stradley.com 215.564.8111

Fund Banking Issues

Attorney:

David F. Scranton .....dscranton@stradley.com.....610.640.5806

ISDAs/Structured Finance Matters/Swaps

Attorneys:

E. Carolan Berkley .....ecberkley@stradley.com.....215.564.8018
Deborah Hong .....dhong@stradley.com.....610.640.5818
David H. Joseph.....djoseph@stradley.com 215.564.8090
Kevin P. Kundra.....kkundra@stradley.com 215.564.8183
Kevin M. Masucci .....kmasucci@stradley.com 215.564.8013

Bankruptcy

Attorneys:

Paul A. Patterson .....ppatterson@stradley.com 215.564.8052
Michael J. Cordone .....mcordone@stradley.com 215.564.8002
Mark J. Dorval .....mdorval@stradley.com.....215.564.8109

Broker-Dealer Regulation

Attorneys:

Merrill R. Steiner .....msteiner@stradley.com 215.564.8039
Lawrence P. Stadulis .....lstadulis@stradley.com.....202.419.8407
Peter M. Hong .....phong@stradley.com 202.419.8429

Money Market Fund Advisory Services

Attorneys:

Joan Ohlbaum Swirsky ....jswirsky@stradley.com 215.564.8015
Kristin H. Ives .....kives@stradley.com 215.564.8037

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STRADLEY RONON
ATTORNEYS AT LAW

Stradley Ronon Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103
Attn: Cheryl Jackson

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