COUNTRY REPORT UNITED STATES 2008

Economic and Financial Background

For the year ending June 2008, U.S. financial markets remained strained. The U.S. financial system has been struggling with a deep contraction in the housing market, mounting losses from rising delinquencies and defaults of sub-prime mortgages, and a liquidity crisis – the severity of which, at times, virtually shut down the functioning of some U.S. markets. The economy grew at an annual rate of 2.2% from June 2007 to June 2008, bolstered by a $168 billion stimulus package that largely took effect in the second quarter of 2008. Builders have continued to significantly curtail construction in the face of falling house prices and rising inventories of unsold homes. From June 2007 to June 2008, residential construction expenditures declined about $105 billion on top of a $98 billion contraction in the previous twelve months. Nationwide house prices were down 15% over the period June 2007 to June 2008, after a 3% decline in the previous twelve months. Many banks confronted with asset write-downs and higher than expected loan losses, have substantially tightened lending standards, thereby reducing the supply of credit to consumers and businesses.

Domestic stock price indexes fell between 12% and 14% from June 2007 to June 2008, as investors assessed the prospects of slower economic growth, weaker corporate profits, and higher inflation. Prices for commodities, such as energy and agricultural products, have soared over the past two years, prompting the Federal Reserve to begin to worry about these increases passing through to non-commodity retail and wholesale prices. Core consumer prices (excluding food and energy) rose 2.4% from June 2007 to June 2008, following an increase of 2.1% over the previous twelve months. Core wholesale prices for finished goods rose 3% from June 2007 to June 2008, following a subdued increased of 1.6% over the previous twelve months.

The Treasury yield curve steepened significantly over the period June 2007 to June 2008. The Federal Reserve aggressively lowered the overnight rate from 5.25% to 2% in a bid to inject liquidity into the financial system and mitigate the effects of the financial crisis on economic activity. Longer-term U.S. Treasury interest rates also fell, but by only 50 and 100 basis points. The value of the U.S. dollar fell about 15% relative to the Euro and Japanese Yen.

High volatility and losses in the equity markets likely prompted many investors to reduce their demand for equity mutual funds. Investors pulled $65 billion, on net,[1] out of mutual funds investing in primarily U.S. stocks (including funds investing in a mixture of stocks and bonds, known as hybrid funds) over the period July 2007 through June 2008. In the previous twelve months, these funds received $13 billion in net new cash flow. Flows into equity funds that invest primarily in non-U.S. equities also weakened considerably. Net new cash flow to these international equity funds totaled $66 billion over the period July 2007 through June 2008, less than half the $141 billion in inflows in the previous year.

Investors' demand for bond funds remained fairly strong during the twelve months ending in June 2008, adding $105 billion of net new cash flow, compared with an inflow of $127 billion in the previous year. The growing popularity of lifecycle and lifestyle funds may have helped to boost bond fund flows. Net inflows to these funds – which often invest their cash in other mutual funds – was $84 billion over the period July 2007 to June 2008. Likely some portion of these inflows was directed to bond mutual funds.

Inflows to money market mutual funds surged during the twelve months ending in June 2008. The financial turmoil in general and illiquidity in credit markets likely led both retail and institutional investors to make greater use of money market funds. Money market funds had net inflows of $767 billion over the period July 2007 to June 2008, more than double the inflow of $339 billion recorded in the previous twelve-month period.

[1] Net new cash flow equals new sales less redemptions plus net exchanges.

Statistical Update on U.S. Fund Activity

[Complete U.S. fund industry statistical trends, updated monthly, are available on the ICI website at www.ici.org/stats/latest/index.html. Comprehensive year-end information is available at www.icifactbook.org.]

Open-Ended Mutual Funds

At the end of June 2008, total U.S. mutual fund assets were $11.68 trillion, with 50% ($5.845 trillion) in equity funds, 29% ($3.402 trillion) in money market funds, 15% ($1.756 trillion) in bond funds and 6% ($675 billion) in hybrid funds.

The $11.68 trillion in total assets represents an increase of $297 billion or 2.7% over the level of June 2007. This change reflects an 11% ($696 billion) decrease in equity funds, a 34% ($866 billion) increase in money market funds, a 10% ($158 billion) increase in bond funds and a 4% ($31 billion) decrease in hybrid funds.

The number of funds as of June 2008 was 8,086, up from 7,984 the year before.

From July 2007 to June 2008, net new cash flow to long-term funds was $106 billion, down 62% from the previous year. New sales and exchange sales totaled $2.554 trillion, or 29% of total assets at the beginning of the period. Redemptions and exchange redemptions of long-term funds were $2.448 trillion, or 28% of assets.

ETFs

Total U.S. ETF assets as of June 2008 were $578 billion, with 92% ($533 billion) in equity index funds and 8% ($45 billion) in bond index funds. This represents an increase of $92 billion or 19% over the $486 billion of ETF assets in June 2007. Net issuance of ETF shares from July 2007 to June 2008 was $141 billion, about double the amount of the previous year. The number of ETFs as of June 2008 was 697, up from 526 the year before.

Closed-End Funds

Total U.S. closed-end fund assets as of June 2008 were $278 billion, with 45% ($125 billion) in equity funds and 55% ($153 billion) in bond funds. This represents a decrease of $44 billion or 16% from the $322 billion of closed-end fund assets in June 2007. The number of closed-end funds as of June 2008 was 653, down slightly from 658 the year before.

Trends in International Investments

As of June 2008, assets of international and global equity and bond mutual funds were $1.6 trillion, down 1.8% from $1.63 trillion in June 2007. These funds represented 19% of total long-term fund assets as of June 2008. There was a $90 billion net inflow to these funds in the twelve-month period ending June 2008, down from the previous year's inflow of $154 billion.

Assets of international and global equity ETFs were $162 billion in June 2008, up 14% from $142 billion in June 2007. These funds represented 28% of total equity ETF assets in June 2008.

Assets of international and global equity and bond closed-end funds were $64 billion in June 2008, down 12% from $73 billion in June 2006. These funds represented 23% of total equity and bond closed-end fund assets as of June 2008.

Regulatory and Self-Regulatory Developments

Summary Prospectus Proposal. Advancing a reform sought by the Institute and the fund industry for more than a decade, the U.S. Securities and Exchange Commission (the "SEC") issued a proposal to allow mutual funds to provide investors with a short-form disclosure document, or "summary prospectus," in place of the full prospectus. The proposal represents a significant step toward achieving streamlined, meaningful disclosure for investors. Under the proposal, funds would be required to advise investors who receive the summary prospectus that more detailed information is available online, and to provide paper copies of the prospectus and statement of additional information promptly upon request at no additional charge. A fund using the summary prospectus on a stand-alone basis would be required to deliver it with or prior to the transaction confirmation, as is currently required of the full-length prospectus. As proposed, the summary prospectus would contain many of the same elements as the risk-return summary section of the existing prospectus. The Institute strongly supports the SEC's proposed concept of a new delivery method for mutual funds, but has significant concerns about certain aspects of the proposal, including a quarterly updating requirement and the inclusion of a fund's top ten portfolio holdings.

Proposed Amendments to Investment Adviser Registration Form. In March 2008 the SEC published for comment proposed amendments to Form ADV, the investment adviser registration form, and related rules under the Investment Advisers Act of 1940. The proposed amendments would replace the current "check-the-box" format and related disclosure schedules with a plain English, narrative brochure that describes the business practices, conflicts of interest, and background of investment advisers and their advisory personnel. Brochures would be electronically filed through the Investment Adviser Registration Depository and made available to the public through the SEC's website. The Institute supports the proposal; the Institute, however, recommends that certain areas of the proposal be improved.

Credit Rating Agency Reform Proposals. The SEC has proposed a comprehensive series of reforms to bring increased transparency to the credit ratings process and curb practices that contributed to the recent turmoil in the credit markets. The SEC's three-step reform proposal includes measures designed to minimize conflicts of interest and to improve investor understanding of credit ratings through enhanced disclosure of methods and performance data. The third part of the SEC's proposal is focused on the ways the SEC's own rules refer to and rely upon credit ratings. The Institute generally supports the SEC's efforts regarding improving transparency as part of credit rating agency reform. The Institute has, however, expressed serious concern with certain aspects of the SEC's proposals, particularly removing ratings from Rule 2a-7 of the Investment Company Act of 1940 (the "1940 Act").

Proposal to Improve Regulation of Foreign Broker Activities in the U.S. The SEC has proposed rule amendments to enhance U.S. investors' ability to access non-U.S. securities markets. Currently, foreign broker-dealers are permitted certain limited contacts with U.S. investors without registering with the SEC. However, the proposal would expand the category of investors that foreign broker-dealers may contact for the purpose of providing research reports and soliciting securities transactions, as well as reduce the role U.S. registered broker-dealers must play in intermediating transactions affected by foreign broker-dealers on behalf of U.S. investors.

SEC XBRL Proposals. The SEC has proposed to require mutual funds to submit information contained in the risk/return summary of the prospectus using eXtensible Business Reporting Language ("XBRL"). XBRL uses data tags to help investors locate and analyze key information about investments. Although the Institute believes that requiring mutual funds to provide this information in XBRL may further the fundamental goal of better serving the information needs of fund investors, the Institute believes that the SEC's proposal is premature. The SEC also proposed to require operating companies, other than investment companies, to submit financial statement information using XBRL. The Institute supports the proposal to exclude investment companies from the XBRL financial statement tagging requirements because the benefits associated with tagging investment company financial statements are limited relative to other types of issuers.

Exchange-Traded Funds Proposal. The SEC in March 2008 issued a proposed rule that would permit index-based and fully transparent actively managed exchange-traded funds ("ETFs") to begin operating without obtaining exemptive relief from the 1940 Act. Under current rules, these ETFs must apply to the SEC for exemptive relief in order to operate. The SEC proposed to codify its previously issued relief in order to eliminate unnecessary regulatory burdens, and to facilitate greater competition and innovation among ETFs. Another provision of the proposal would permit mutual funds and other investment companies to invest in ETFs to a greater extent than currently permitted by the 1940 Act. The Institute generally supports these proposals.

Proposal to Mandate EDGAR Filing of Exemptive Applications. The SEC in November 2007 proposed several rule amendments to its Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system, including a requirement that all applications for orders under the 1940 Act be submitted electronically through EDGAR. The proposal also requires electronic submission of Regulation E filings by small business development companies and business development companies. Currently, all applications for exemptive orders under the 1940 Act (other than investment company deregistration applications) must be filed with the SEC in paper form. Copies of filed applications are available through the SEC's public reference room or through a private vendor for a fee.

Qualified Default Investment Alternatives. In October 2007 the Department of Labor (the "DOL") issued final regulations with respect to the qualified default investment alternatives ("QDIA") available to employers who automatically enroll their employees in a 401(k) plan. The regulations, which implement provisions of the Pension Protection Act of 2006, are consistent with the position that the Institute strongly endorsed and defended. The safe harbor for QDIAs covers lifecycle and balanced funds and managed account programs. The regulation also allows an employer to use a capital preservation product, such as a money market fund, as a default investment, but only for the first 120 days after an employee is automatically enrolled.

Department of Labor Fee Disclosure Proposals. The DOL launched a three-part regulatory effort to reform 401(k) fee disclosure. First, the DOL released guidance on the new Form 5500 requirements for disclosure of payments to plan service providers. Second, the DOL released proposed rules that would require, as a condition of the contract between the service provider and the plan, that service providers to ERISA-governed plans provide plan fiduciaries with significant compensation and conflict of interest disclosures. Third, the DOL released proposed rules to require participants in 401(k) plans to receive basic information, including disclosure of fees and expenses, on all of the plan's investment options, regardless of the type of investment, with access to additional information on a website or upon request.

Tax Law Developments. Significant attention has been directed to potential tax legislation to: (1) restrict the broadening application to more moderate-income investors of the so-called alternative minimum tax, which originally was intended to apply only to the wealthiest taxpayers; (2) extend various expiring provisions of current law, including "flow-through" provisions that permit foreign investors in U.S. funds to receive distributions attributable to interest and short-term capital gains without incurring U.S. withholding tax; (3) extend some or all of the broad-based tax cuts enacted in 2001 and 2003, including lower maximum rates on dividends and long-term capital gains, that expire at the end of 2010; and (4) permit investors to defer tax on automatically reinvested capital gain dividends. The "flow-through" legislation may be extended this fall, along with legislation that eventually would require funds and brokers to report to their customers the cost basis (and gain or loss) when securities, including mutual fund shares, are sold. The cost of extending fully the 2001 and 2003 tax cuts would be significant; by some estimates, the cost of extending these cuts for another ten years could reduce U.S. federal tax revenues by $2.4 trillion. The Institute anticipates federal tax legislation being a priority in the year ahead.

Corporate Governance Developments

Shareholder Proposals. The SEC in December 2007 amended Rule 14a-8(i)(8) under the Securities Exchange Act of 1934 to clarify the scope of the rule's exclusion for any shareholder proposal relating to an election of directors and, in doing so, codified the SEC's long-standing interpretation of that exclusion. According to the adopting release, the SEC amended the rule to make clear that a shareholder proposal calling for a company to amend its bylaws to establish procedures for permitting shareholder-nominated directorial candidates to appear on the company's proxy can be excluded from the company's proxy on the basis that the proposal "relates to an election of directors" under Rule 14a-8(i)(8). At the same time the amendments to Rule 14a-8(i)(8) were proposed, the SEC also issued a second release that proposed a comprehensive package of amendments to the proxy rules and related disclosure requirements.

Fund Governance Developments

Federal Appeals Court Takes New Approach in Mutual Fund Fee Case. The U.S. Court of Appeals for the Seventh Circuit, in the case of *Jones v. Harris Associates*, ruled that courts generally should not be involved in determining the appropriate level of mutual fund fees. These decisions, rather, should be left to fund trustees and market competition. Noting its disapproval of *Gartenberg v. Merrill Lynch Asset Management, Inc.*, the court pointed out that "Section 36(b) does not say that fees must be 'reasonable' in relation to a judicially created standard. It says that the adviser has a fiduciary duty." The decision is not binding on courts in other circuits. The plaintiffs in this case are seeking Supreme Court review.

Product Developments

Managed Payout Funds. A few mutual fund companies have recently begun to offer "managed payout funds." These funds, which appeal largely to retirees, are designed to provide regular monthly payouts through a built-in systemic withdrawal plan and offer investors full access to their funds in case of emergency. Withdrawal options from managed payout funds range from moderate to high. Moderate payout funds seek to deliver monthly income and provide capital growth of the investment. High payout funds seek to preserve the initial capital investment only. Monthly payouts are not guaranteed and can vary depending on market conditions and the actual return of the portfolio. In addition, these funds may need to return capital to investors to maintain the distribution of monthly payouts. As of July 2008 only a few mutual fund companies had launched such funds, but a number of other companies are planning to do so.

Short-Extension Funds. Mutual funds with alternative investment strategies, such as short-extension funds (*e.g.*, 130/30 funds), have continued to generate interest. As of June 2008 approximately 150 mutual funds, with assets of approximately $50.6 billion, used shorting of stocks and options (not commodities or fixed income) as a significant part of the fund's strategy.

Other Developments

Treasury Department Blueprint for a Modernized Financial Regulatory Structure. In April 2008 the U.S. Treasury Department issued a blueprint for reform of the regulatory structure for U.S. financial institutions. The blueprint contains: (1) short-term recommendations to improve regulatory coordination and oversight in the wake of recent market events; (2) intermediate-term recommendations to minimize duplication of the U.S. regulatory system and modernize the financial regulatory structure; and (3) a conceptual model for instituting an objectives-based, regulatory framework. For the fund industry, one of the most significant proposals concerns the recommendation for the proposed merger of the SEC and the Commodity Futures Trading Commission. In addition, consistent with the Institute's submission to the Treasury Department, the blueprint calls for the SEC to propose legislation establishing a new form of registered investment company for the global marketplace.

Review of Rule 12b-1 Fees. The review of Rule 12b-1 – which permits mutual funds to use fund assets to pay for the sale of fund shares and other distribution-related activities – continues to be a priority for the SEC. The Director of the SEC's Division of Investment Management, Andrew "Buddy" Donohue, laid out a number of "significant concerns" related to Rule 12b-1 and the fund distribution system, including investor confusion regarding the purpose of 12b-1 fees, treatment of fund investors in various retail share classes, and outdated guidance concerning the board's responsibilities under Rule 12b-1. Mr. Donohue explained that, in preparing a recommendation for the SEC, the Division "does not want to dismantle the good with the bad, but [is] committed to addressing important investor protection issues." In June 2007 the SEC encouraged all interested persons to comment on issues relating to Rule 12b-1 under the 1940 Act. In response to this request, the Institute filed a comment letter with the SEC. The letter supports the SEC's review of Rule 12b-1, but urges the SEC to refrain from making changes that would fundamentally alter the way Rule 12b-1 operates or that would fully or partially rescind the rule. Instead, the letter states that any changes to Rule 12b-1 should be limited to those that refine or enhance the rule, such as changes that would clarify the role of the board under the rule and provide better disclosure of 12b-1 fees.