Recent Investment Management Developments

February 2014

Below is a summary of recent investment management developments that affect registered investment companies, private equity funds, hedge funds, investment advisers, and others in the investment fund industry.

Trend: Advisers Attacked for Overcharges on Subadvised Funds

In February 2014, shareholders sued Harbor Capital Advisors over amounts being paid in relation to advising the Harbor International Fund. The suit alleges that the subadviser, Northern Cross, was doing most of the work, but that Harbor Capital Advisors was nonetheless retaining $225 million (2012 figures).

Harbor Capital is the latest of several lawsuits that allege excessive mutual fund fees for subadvised funds.

SEC Delays Implementation of Municipal Adviser Registration Rules

In September 2013, the Securities and Exchange Commission (SEC) voted to adopt a final rule establishing a permanent registration regime for municipal advisers. Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), municipal advisers were not required to register with the SEC. Section 975 of Dodd-Frank made it unlawful, however, for any municipal adviser to provide advice to or on behalf of a municipal entity or obligated person, or to undertake certain solicitations of a municipal entity or obligated person, absent registration with the SEC. Dodd-Frank also required the SEC to adopt a rule requiring municipal advisers to register with the SEC and comply with a set of regulations that would be issued by the Municipal Securities Rulemaking Board.

Very recently, the SEC has delayed the effectiveness of the municipal adviser registration rules. The rules will now go into effect on July 1, 2014.

SEC Warns of Fixed Income Fund Risk

In January 2014, the SEC's Division of Investment Management issued guidance to fund advisers and boards on the risks of changing fixed income market conditions.[1] The guidance warns of the importance of sound risk management and disclosure practices by fixed income mutual funds and exchange-traded funds (ETFs), particularly as the Federal Reserve Board implements the end of its regimen of "quantitative easing."

The staff guidance notes that markets buffeted bond mutual funds and ETFs in June 2013, when the 10-year Treasury note yield rose by almost 50 basis points.[2] The staff believes that such volatility is likely to be a near permanent development as a result of structural changes in the fixed income marketplace, which has grown much faster than the size of primary dealers' inventories. The staff believes that the size of dealer inventories is a proxy for their appetite and capacity to make markets by committing their own capital, as principal, to market intermediation. The staff believes that a significant reduction in dealer market-making capacity has the potential to decrease liquidity and increase volatility in the fixed income markets.

The staff guidance recommends several steps that fixed income fund advisers may consider taking, and it also notes that fund boards may want to consider discussing with fund advisers the steps these advisers are taking in this area.

SEC Fines Adviser over Social Media Advertising

The SEC settled a claim against Mark Grimaldi of Navigator Money Management over allegedly misleading tweets about the firm's performance record. The SEC charged the investment adviser with having made false statements and having "cherry-picked" information in a misleading fashion in an effort to attract new clients by use of Twitter. The regulator's message: social media statements are no different from any other statements and carry the same risks and restrictions. Grimaldi paid a $100,000 fine.

PCAOB Evaluating Significant Changes to Auditor's Report

The Public Company Accounting Oversight Board (PCAOB) is evaluating comments on its 2013 proposal for significant changes to the auditor's report. The proposed standard would require the auditor to report a wider range of information specific to the particular audit and auditor. For example, the auditor would be required to communicate in a separate section of the audit report the "critical audit matters" (CAM) in the audit of the current period's financial statements based on the results of the audit or evidence obtained. CAM are those matters the auditor addressed during the audit of the financial statement that:

- Involved the most difficult, subjective, or complex auditor judgments
- Posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence
- Posed the most difficulty to the auditor in forming an opinion on the financial statements.

The proposed auditor reporting standard identifies factors the auditor should take into account in determining CAM, including:

- The severity of control deficiencies identified relevant to the matter, if any

- The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any.

The auditor's report would (1) identify the CAM; (2) describe the considerations that led the auditor to determine that the matter is a CAM; and (3) refer to the relevant financial statement accounts and disclosures that relate to the CAM, when applicable.

Other provisions of the proposal would require:

- A statement containing the year the auditor began serving consecutively as the company's auditor (apparently instead of requiring mandatory rotation of audit firms)

- A statement that the auditor is a public accounting firm registered with PCAOB (United States) and is required to be independent from the company in accordance with federal securities laws and the applicable rules and regulations of the SEC and the PCAOB

- Enhancements to existing language in the auditor's report related to the auditor's responsibilities for fraud and the notes to the financial statements.

Final Volcker Rule Adopted

More than two years after originally proposed, the final Volcker Rule, implementing Section 13 of the Bank Holding Company Act (added by Dodd-Frank),[3] was released in December 2013. The rule is attributed to former Federal Reserve Board Chairman Paul Volcker, and its principal idea is to prevent banks from taking undue risks while enjoying the benefits of the public subsidy conferred by insured deposits.

As required by Dodd-Frank, the Volcker Rule prohibits a "banking entity" from two broad categories of activities:

- Engaging in proprietary trading of financial instruments (i.e., the purchase or sale of securities, commodity contracts (including FX swaps and forwards), derivatives, or options) for its own "trading account" with the idea of profiting from short-term price movements

- Owning and sponsoring hedge funds and certain private equity funds (known as "covered funds")

The rule defines "banking entity" as:

- Any insured depository institution (i.e., a commercial bank or a thrift)

- Any company that controls an insured depository institution (i.e., a bank holding company or a savings and loan holding company)

- Any company that is treated as a bank holding company under the International Banking Act of 1978 (i.e., a company that is or controls a non-U.S. bank with branches or agencies in the United States)

- An affiliate or subsidiary of any of the above

In large part, the final rule is unchanged from the original proposal. However, although the proposed rule required banking entities to implement significant compliance programs, the final rule gives some relief to smaller institutions but expands the obligations of large institutions (typically those with $50 billion or more in total consolidated assets). Large institutions are subject to an expanded corporate governance and oversight requirement for boards of directors, CEOs, and senior management; this includes a requirement for an annual CEO certification.

The final rule extends the compliance date for most of its requirements until July 21, 2015.

House Passes Bill Exempting Advisers to Private Equity Funds from Registration under the Advisers Act

In a mild backlash against what some lawmakers perceive as unnecessary overregulation, the House of Representatives in December 2013 passed a bill that exempts advisers to private equity funds from having to register as investment advisers under the Investment Advisers Act of 1940 (the Advisers Act).[4] In effect, the bill would set the clock back for such advisers to the time before the effectiveness of Dodd-Frank , which changed the Advisers Act and related rules to require advisers of private funds to register, among other things. As a condition for eligibility for this exemption, a private equity adviser must not have borrowed and have outstanding a principal amount more than twice its invested capital.

Framed as a jobs-creation measure, the bill received support from most Republicans and more than a few Democrats, passing 254-159. The chance of the measure becoming law in the near term is small. Not only are the White House and the SEC opposed to it, it also lacks a sponsor, let alone majority support, in the Senate.

Champ Reviews Changes to Regulatory Landscape for Hedge Funds

Norm Champ, the director of the SEC's Division of Investment Management, recently urged hedge fund advisers to review their policies and procedures carefully to ensure that they are reasonably designed to prevent fraudulent or misleading advertisements, particularly if the hedge fund sponsors intend to engage in general solicitation activity (see article below). Such advisers should also consider the requirements of the new rule. The staff plans to evaluate the range of accredited investor verification practices that issuers and offering participants use to identify trends in the market, including potentially fraudulent behavior, according to Champ.

EB-5 Funds under Renewed SEC Scrutiny

Announcements in October by the SEC and U.S. Citizenship Immigration Services (USCIS) indicate that investments made through the EB-5 Immigrant Investor Program (the EB-5 Program) will be subject to heightened scrutiny. On October 1, the SEC announced fraud charges against a husband and wife in McAllen, Texas, for allegedly stealing funds from foreign investors seeking U.S. residency through the EB-5 Program. On the same day, the SEC and USCIS issued a joint Investor Alert to educate and warn investors about fraud in the program.

These actions make clear that both the SEC and USCIS are closely monitoring the EB-5 Program and are willing to devote substantial resources to counter even relatively small instances of fraud.

In particular, the enforcement action demonstrates that the SEC will scrutinize applications for U.S. economic development projects, designated as "Regional Centers," to ensure that funds raised correlate to the Regional Center's stated purpose and are used for approved Regional Center projects.

The EB-5 Program, administered by USCIS, enables certain foreign investors to earn conditional permanent residency, and eventually green cards, by making "at risk" investments of at least $500,000 in Regional Centers that create or preserve jobs for U.S. workers.

Before obtaining lawful permanent residency, however, a foreign investor must demonstrate that the investment funds were actually used to create or preserve jobs for qualifying U.S. workers. Particularly since the economic downturn, project developers increasingly have turned to the EB-5 Program to raise capital for projects that frequently are in the hundreds of millions of dollars.

The SEC's enforcement action alleges that Marco and Bebe Ramirez fraudulently raised and misappropriated at least $5 million from investors by falsely promising that their money would be invested as part of the EB-5 Program. The couple allegedly diverted the investors' funds for personal use and, in at least one instance, made a Ponzi-like payment to an existing investor, according to the SEC's complaint. The U.S. District Court for the Southern District of Texas has granted the SEC's request to freeze the defendants' accounts and assets, essentially halting their ability to obtain additional investors.

The SEC alleged that in addition to allegedly falsely representing to investors that their investments would qualify them for conditional, and later, permanent residency under the EB-5 Program, the defendants also falsely informed investors that their funds would be held in escrow pending the issuance of conditional visas by USCIS. Yet, rather than retain the investor funds in an escrow account, the SEC claims that the defendants immediately disbursed the money, sometimes on the same day an investment was received.

Further, instead of directing investments into the purported EB-5 project, the couple allegedly misappropriated the funds, using:

- $485,000 to settle an unrelated civil lawsuit
- At least $500,000 making a Ponzi payment to a prior investor
- At least $1 million to open a Cajun-themed restaurant
- Other investor funds to purchase vehicles for themselves and USA Now employees

None of the investors identified by the SEC has received a conditional visa from USCIS, and none of the investment funds remain in escrow.

Mutual Fund Insider Trading Case Remanded

The Seventh Circuit recently examined for the first time, but left unresolved, the question of whether the misappropriation theory of insider trading may be used to impose Section 10(b) liability regarding the redemption of mutual fund shares.[5] The SEC brought claims alleging insider trading and other securities law violations against Jilaine Bauer, the general counsel and chief compliance officer of Heartland Advisors, Inc. (Heartland), an investment adviser and broker-dealer in Milwaukee, Wisconsin. The Seventh Circuit acknowledged that the action was one of a few instances in which the SEC had brought insider trading claims in connection with a mutual fund redemption, and remanded the case so the district court could rule on whether the misappropriation theory of insider trading applied.

Heartland managed the portfolios for Heartland Group, Inc., an open-end management investment company, and also underwrote and distributed shares of its mutual funds, which included certain municipal bond funds (the Funds). Beginning in 1999 and through the time Bauer redeemed her shares, the Funds experienced substantial net redemptions, and bonds in the Funds' portfolio defaulted or were at risk of default. In the midst of the redemption and credit problems, a Fund manager tendered his resignation. In August 2000, Bauer imposed trading restrictions on all Heartland personnel who were aware of the impending resignation. In late September 2000, Bauer lifted the trading ban. A few days later, Bauer redeemed all of her shares in the Funds for approximately $45,000. The Funds' net asset values continued to decline, and the Funds entered receivership five months later. In December 2003, the SEC filed suit against Heartland, Bauer, and several other executives of Heartland. All the defendants except Bauer entered into settlement agreements with the SEC. On May 25, 2011, the district court granted summary judgment to the SEC on the insider trading charges against Bauer. The decision was premised on (1) the parties' stipulation that Bauer was an insider who possessed nonpublic information at the time she sold her shares and (2) the district court's findings that there were no genuine issues of material fact that the information Bauer possessed was material and that she acted with scienter. Bauer appealed.

Section 10(b) of the Securities Exchange Act of 1934 prohibits fraud in connection with the purchase or sale of a security. To prove a violation of Section 10(b), the SEC had to establish that Bauer (1) made a material misrepresentation or a material omission as to which she had a duty to speak, (2) with scienter, and (3) in connection with the purchase or sale of securities. There are two general theories to explain how insider trading violates Section 10(b). Under the "classical theory," when a corporate insider trades in the securities of his or her corporation on the basis of material, nonpublic information, the relationship of trust between the shareholders and the insiders has been breached.[6] Under the "misappropriation theory," a corporate insider misappropriates confidential information for securities trading purposes in breach of a duty owed to the source of the information, and the disclosure obligation "runs to the source of the information."[7] The outsider entrusted with confidential information must either refrain from trading or disclose to the principal that he plans to trade. The misappropriation theory is "designed to protect the integrity of the security markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to the corporation's shareholders."[8]

The Seventh Circuit articulated that the threshold issue is whether, and to what extent, insider trading theories apply to mutual fund redemptions—a question that had never been directly addressed in federal court. The SEC argued on appeal that Bauer's conduct fit under the misappropriation theory of insider trading; however, it never presented the misappropriation theory to the district court. Rather, it relied on the classical theory. The Seventh Circuit remanded on several grounds, and also expressed skepticism as to the application of the misappropriation theory, stating "the misappropriation theory may overlook certain structural realities of a mutual fund. For example, the Commission might unravel for the district court how an officer at a mutual fund investment adviser can be fairly considered a corporate 'outsider' given the investment adviser's deeply entwined role as sponsor and external manager of the fund." [9] Another important question to be answered on remand is whether, in the context of a mutual fund (where the fund itself is the buyer), there can ever be nondisclosure because the buyer knows all the material facts that the seller knows.

Government Shutdown and Debt Limit Roils Markets

The 2013 brinkmanship over the U.S. government's debt ceiling, coupled with a three-week federal government shutdown—following immediately on the heels of the expected reduction in open market bond purchases by the Federal Reserve—caused markets to become extremely turbulent in the summer and early fall of 2013. Between May 1 and early September, annual interest rates on the 10-year Treasury bond increased from 1.63% to more than

3.00%. After backing down 40 basis points or so in the wake of the announcement that Fed tapering would be postponed, many short rates spiked in mid-October over the threatened U.S. government securities default. The 10-year Treasury bond also edged back toward 2.75%. With the resolution of the crises, the 10-year Treasury bond sank back below 2.60%. At the height of the default threat, credit default swaps on 1-year Treasuries had increased 50 basis points as compared to an increase on German bunds of only 3 basis points. Equity volatility increased as well.[10]

Subsequent to the Fed's eventual tapering announcement in December, interest rates have increased steadily. The increase in interest rates has had several effects. First, fixed income securities have been declining in value. This, combined with the prospect of additional future interest rate increases, has helped to fuel large investor outflows from fixed income funds.[11] Second, in the late fall, emerging market equity securities suffered what some analysts referred to as a 1990s-style Asian market crisis, which has prompted investor flight out of EM funds, some of which are liquidating as a result of sizable redemptions. On average, the five-year bond interest rate in emerging markets has increased from about 7% per year to about 10% per year in an effort to stem currency conversions and investment outflows.[12] Third, municipal bonds have suffered even steeper increases in interest rates than Treasury bonds due to the "Detroit bankruptcy premium"—-over the same time period the AAA MMD 10-year muni benchmark has increased by 14 basis points more than a Treasury bond with comparable maturity. (One municipal analyst has referred to the change in the municipal bond market as a "Lehman-like" move.[13]) Fourth, mortgage interest rates have spiked sharply in tandem with the increase in interest rates on the ten-year Treasury bond.

New IRS Regulations Applicable to Corporations Electing RIC Status

On August 1, 2013, the IRS released new regulations relating to the treatment of corporations electing regulated investment company (RIC) status that have been subject to regular corporate income tax. Since 1987, the tax law has been clear that any such corporation would be subject to corporate income tax on any gains in the value of its assets that had accrued before the date of its RIC election and that were realized (such as by a sale) in the 10-year period following the election. In addition to sales made following RIC elections by existing corporations, this 10-year recognition rule applies to corporate assets acquired in other tax-free transactions (such as a merger of a corporation into an existing RIC).

The new regulations create an exception for assets transferred to a RIC by a tax-exempt organization (whether through merger or election by the tax-exempt organization of RIC status) where a sale of the transferred assets by the tax-exempt organization would not have been subject to any federal income tax (including the unrelated business income tax imposed on tax-exempt organizations). This change was necessitated by the fact that tax-exempt organizations are uniformly classified as corporations for federal income tax purposes regardless of their state law form of organization and thus, technically, have been subject to the 10-year recognition period rules. Although it is unlikely that a public charitable organization would want to elect RIC status, certain private foundations might find this regulatory change to be useful.

The new regulations also extend the 10-year recognition rule to partnerships owned wholly or in part by corporations that reorganize as RICs or that contribute property to RICs in kind to the extent of any built-in gain that would be allocable to the corporate partners if the partnership property had been sold as of the date of the reorganization or contribution. Private equity funds that are organized as partnerships, have corporate partners, and seek to become RICs are one obvious target of this new rule.

The new regulations fully apply to transactions occurring on or after August 2, 2013, although the provisions relating to tax-exempt organizations and partnerships that are described above may be applied retroactively at the election of the taxpayer.

Board Actions during Annual Advisory Agreement Renewal Process under SEC Scrutiny

The Asset Management Unit of the Enforcement Division of the SEC continues its close examination of the annual investment advisory agreement renewal process. In August 2013 the SEC charged a North Carolina-based investment adviser, Chariot Advisors, and its former owner, Elliott Shifman, with violating and aiding and abetting the violation of Section 15(c) of the 1940 Act.[14]

The SEC alleged that Chariot Advisors sought to win additional business by misleading the board of The Northern Lights Funds. Specifically, Chariot Advisors and Shifman allegedly lied about their ability to run an algorithmic currency trading strategy as a selling point in communications to the board during the 15(c) process for a proposed fund, the Chariot Fund. In PowerPoint presentations, in other written submissions, and during in-person presentations before the board, Shifman stated that Chariot Advisors would use algorithmic currency trading for the fund, according to the SEC. The SEC alleged that, in reality, Chariot Advisors did not possess any algorithms for conducting currency trading. The SEC further alleged that Chariot Advisors did not implement algorithmic trading for the Chariot Fund for at least the first two months after its launch.

The SEC order points out that the ability to conduct currency trading for the Chariot Fund was particularly significant for the Chariot Fund's performance, because in the absence of an operating history by which to judge performance, the board of Northern Lights focused on Chariot Advisors' reliance on models in evaluating the advisory contract. The implementation of the currency trading strategy was also important, the SEC order points out, because Shifman had indicated that the S&P 500 Index would be an appropriate benchmark for the Chariot Fund's performance. For the Chariot Fund to achieve a return comparable to the S&P 500 Index, the Chariot Fund, with 80% of its assets invested in fixed income securities, would have to achieve a 25% to 30% return on its currency trading activities. As a result of the conduct described above, the SEC alleged that Chariot Advisors willfully violated Section 15(c), and Shifman willfully aided and abetted and caused this violation.

According to the SEC press release accompanying the publication of the SEC order instituting *In re Chariot Advisors*, this matter arose out of an initiative by the Asset Management Unit of the Enforcement Division of the SEC to scrutinize the 15(c) process. A fund board should take note that, in *In re Chariot Advisors*, the SEC examined the various disclosures made to the board during the 15(c) process in question. A fund board should thus be sensitive to the need for consistency across all such communications. As of January 2014, this matter was scheduled for a hearing in February 2014.

In re Chariot Advisors is at least the fourth enforcement case which the SEC's specialized asset management unit has brought in connection with its compliance sweep with laws requiring fund boards to evaluate their agreements with investment advisers, and closely follows another investigation involving the Northern Lights Funds. On May 2, 2013, the SEC announced that the gatekeepers of the Northern Lights Fund Trust and the Northern Lights Variable Trust (the Funds), settled allegations that they caused false or misleading disclosures about what they considered in approving or renewing investment advisory contracts. According to the SEC, the trustees and the trusts' chief compliance officer, Northern Lights Compliance Services (NLCS), were responsible for causing violations of the SEC's compliance rule, and the trusts' fund administrator, Gemini Fund Services (GFS), caused violations of the Investment Company Act of 1940 (the 1940 Act) recordkeeping and reporting provisions.

During the annual advisory agreement renewal process, all mutual fund directors must evaluate a fund's contract with its investment adviser, and the funds must report back to shareholders about the material factors considered by the directors in making the decision on renewal. The SEC's order found that some boilerplate disclosures related to the process, which were included in the Funds' shareholder reports, contained untrue or misleading information. For example, the SEC reported that one disclosure falsely claimed that the trustees had considered peer group information about the advisory fee, when no such data had been provided to the trustees. It went on to report that "other disclosures misleadingly indicated that the fund's advisory fee was not materially higher than its peer group range, when in fact the fee was nearly double the peer group's mean fee or even higher." Further, the SEC found that certain mutual fund series did not follow their policies and procedures for the trustees' approval of the investment advisers' compliance programs.

"Determining the terms of the investment advisory contract, especially compensation of the adviser, is one of the most critical duties of a mutual fund board," said George S. Canellos, Co-Director of the SEC's Division of Enforcement. "We will aggressively enforce investors' rights to accurate and complete information about the board's process and decision-making."

Without admitting or denying the SEC's findings, GFS and NLCS each agreed to pay $50,000 penalties, and the firms and the trustees agreed to engage an independent compliance consultant to address the violations found in the SEC's order. They also agreed to cease and desist from committing or causing any violations and any future violations of those provisions.

SEC Charges Oppenheimer Subadviser with Misleading Valuations

Continuing the drumbeat of valuation enforcement, in August the SEC charged a former Oppenheimer & Co. portfolio manager with misleading investors in the private Oppenheimer Global Resource Private Equity Fund I, L.P. (OGR), a fund of funds with intentionally and substantially inflating the value of OGR's largest underlying holding.

As in the case of the Morgan Keegan funds (described below), a portfolio manager exercised undue influence on the valuation process that led to an inappropriate increase in the value of OGR's largest holding. The internal rate of return for OGR went from 3.8% to 38.3% as a result of the misvaluation.

According to the SEC complaint, the former portfolio manager left Oppenheimer at the end of 2011 when he formed an investment adviser that began subadvising OGR.

In an administrative proceeding in March 2013, Oppenheimer Asset Management Inc. and Oppenheimer Alternative Investment Management LLC agreed to pay about $2.9 million in restitution and penalties as a result of this misvaluation of holdings.[15] Despite the charges and payment, Oppenheimer continues to use the former portfolio manager as a subadviser for OGR.

Unlike the Morgan Keegan case, no charges were brought against individual fund trustees because the Oppenheimer fund was private and not subject to the same requirements as mutual funds. Nonetheless, the proceeding further underscores the SEC's emphasis on valuation of securities.

CFTC Harmonizes Compliance Obligations for Dually-Registered Commodity Pool Operators with SEC Regulation

In August, the Commodity Futures Trading Commission (CFTC) adopted rule amendments[16] to accept compliance with the disclosure, reporting, and recordkeeping system adopted by the SEC as satisfactory to satisfy the CFTC compliance requirements for dually registered commodity pool operators (CPOs). Last year, the CFTC had adopted original amendments[17] that narrowed an exclusion from the definition of CPO for RICs that operate commodity pools. The exclusion, under Rule 4.5,[18] had been available since 2003 and was a blanket exclusion of SEC-registered investment companies from CFTC oversight, no matter what their involvement in CFTC jurisdictional markets. The amendments to Rule 4.5 will subject most funds investing in commodity-related instruments to dual registration requirements by the CFTC and SEC.

The U.S. Chamber of Commerce and the Investment Company Institute (the ICI) commenced suit to enjoin enforcement of the rule amendments, but the U.S. District Court for the District of Columbia in December 2012 issued a ruling that upheld the CFTC rulemaking. On appeal, the Court of Appeals for the District of Columbia Circuit held that the rule was supported by "reasoned decision-making" in accordance with law.

The harmonization rule adopted by the CFTC broadens the approach previously proposed and will, presumably, tamp down the original dissatisfaction that prompted the ICI and Chamber litigation.

Registered funds can still qualify for the exemption if they limit futures trading (at time of investment) to 5% of the fund (measured by margin plus premium) or 100% of the fund by notional amount. Similar exemptions are available to hedge funds under the new CFTC regime.

The CFTC also rescinded Rule 4.13(a)(4). As a result, certain previously exempt hedge funds now must register as CPOs and comply with CFTC recordkeeping and disclosure rules. Hedge funds and other entities (that are not RICs) affected by this rescission of Rule 4.13(a)(4) have not sought judicial review of it.[19]

SEC Adopts Rules To Eliminate Prohibition on General Solicitation and Advertising

In July 2013, the SEC adopted new rules that eliminate the long-standing prohibition against general solicitation and advertising in securities offerings made in reliance on Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933 (the Securities Act).[20] On the same day, the SEC adopted rules to expand the prohibition on "bad actors" from participating in private securities offerings.[21] In addition, the SEC issued proposed rules that would provide additional information about general solicitation and advertising used in connection with Rule 506 offerings.[22] In particular, the proposed rules would, among other things, amend Rule 156 under the Securities Act to apply that rule's guidance to sales literature used by private funds that use general solicitation in a Rule 506 securities offering.

According to the final rules that lift the ban on general solicitation in Rule 506 offerings, the ability of an issuer to use general solicitation and advertising is conditioned on the issuer taking reasonable steps to verify that purchasers of the securities are accredited investors. Though such issuers face restrictions on who may purchase the offered securities, there is no limitation on whom the issuers can solicit in the offering. The final rules provide a non-exclusive list of four methods that issuers can use to satisfy the verification requirement for investors in situations where the investors are natural persons.

Many private funds—including many hedge funds, venture capital funds, and private equity funds—offer their shares in reliance on Rule 506. "Private funds," as that term is used here, are investment companies which rely on an exclusion from the definition of "investment company" under the 1940 Act, and are thereby not subject to substantially all of the regulatory provisions of the 1940 Act. A major effect of the removal of the ban on general solicitation is that private funds will now be able to employ virtually any means of mass communication to inform potential investors about Rule 506 offerings if they are prepared to meet the heightened reporting standards. Physical forms of solicitation could include mailings, newspaper advertisements, and billboards. Electronic forms could include the internet, social media, e-mail, and television.

Such general solicitation will entail additional burdens for an issuer that uses it. As noted above, an issuer that intends to engage in general solicitation as part of a Rule 506 offering would be required to take reasonable steps to verify that the investors are accredited investors. Also, the proposed rules (issued in connection with the SEC's adoption of the final rules that lifted the ban on general solicitation) would, if adopted as proposed, impose additional reporting obligations on such issuers. These obligations would include the requirement that the issuer file a Form D (the notice of an offering of securities made without registration under the Securities Act) at least 15 calendar days before engaging in general solicitation for the offering. Also, within 30 days of completing an offering, the issuer would be required to update the information contained in the Form D and indicate that the offering has ended. If an issuer were to fail to comply with these requirements, the issuer would be disqualified for a period of time from using the Rule 506 exemption. The disqualification would last for one year, beginning after the required Form D filings are made. Issuers would have a 30-day cure period to remedy a missed Form D filing deadline, and, in certain circumstances, could ask the SEC to waive the disqualification.

We believe this change will encourage an already existing trend toward the convergence of alternative funds and registered funds. However, as of early February, 2014, most established private funds are taking a "wait and see" approach to the change, in part because of the additional burdens referred to above and in part due to their ability to raise desired capital without having to rely on the new rules.

Commissioner Luis Aguilar urged the SEC in December to "move promptly" on proposed amendments that would help it monitor the new regime.

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1 Risk Management in Changing Fixed Income Market Conditions, IM Guidance Update 2014-1 (Jan. 2014), http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf.

2 Please see the article about this volatility at page 6.

3 Pub. L. No. 111-203, 124 Stat. 1376 (Dodd-Frank Act); 12 U.S.C. § 1851 (new Section 13 of Bank Holding Company Act).

4 Small Business Capital Access and Job Preservation Act, H.R. 1105, 113th Cong. (2013).

5 *SEC v. Bauer*, 723 F. 3d 758 (7th Cir. 2013).

6 *Chiarella v. United States*, 445 U.S. 222 (1980).

[7] *U.S. v. O'Hagan*, 521 U.S. 642 (1997).

[8] *Id.*

[9] 723 F. 3d at 772.

[10] The CBOE VIX index of volatility almost doubled from the low teens in May to about 23 in late June. Although small by comparison to the spikes in volatility seen during the financial crisis and its aftermath, the increase was nonetheless substantial.

[11] In June and July, fixed income funds had aggregate net outflows of $75 billion. Investment Company Institute data at www.ici.org/research/stats (visited August 26, 2013). In the middle two weeks of August, fixed income funds bled an additional $15 billion, two-thirds from taxable funds and the balance, from municipal funds. *Id.* In the third quarter, all together, bond funds bled between $60 and $70 billion.

[12] Source: JP Morgan Chase.

[13] Alan Schankel and Tom Kozlik of Janney Montgomery Scott Inc., as quoted in MarketWatch http://blogs.marketwatch.com (visited August 23, 2013).

[14] *In re Chariot Advisors, LLC*, Admin. Proc. No. 3-15433, Investment Company Act Release No. 30655 (Aug. 21, 2013).

[15] Press Release, Sec. Exch. Comm'n, *SEC Charges New York-Based Private Equity Fund Advisers with Misleading Investors about Valuation and Performance* (Mar. 11, 2013), *available at* http://www.sec.gov/news/press/2013/2013-38.htm.

[16] *Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators*, 78 Fed. Reg. 52,308, (Aug. 22, 2013) (to be codified at 17 C.F.R. pt. 4), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister081213.pdf.

[17] Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations, 76 Fed. Reg. 7,976 (Feb. 11, 2011); Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations, 77 Fed. Reg. 11,252 (Feb. 24, 2012).

[18] 17 C.F.R. § 4.5.

[19] *Brief For Commodity Futures Trading Commission*, *Inv. Co. Inst. v. U.S. Commodity Futures Trading Comm'n*, No. 12-5413 (D.C. Cir. 2013), at 2, *available at* http://www.ici.org/pdf/13_cftc_brief_appeal.pdf.

[20] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415; Release No. 34-69959; Release No. IA-3624 (July 10, 2013), *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

[21] Disqualification of Felons and Other "Bad Actors" from Rule 506 Offerings, Release No. 33-9414 (July 10, 2013), *available at* http://www.sec.gov/rules/final/2013/33-9414.pdf.

[22] Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Release No. 33-9416; Release No. 34-69960; Release No. IC-30595 (July 10, 2013), *available at* http://www.sec.gov/rules/proposed/2013/33-9416.pdf.