Ballard Spahr LLP

INVESTMENT MANAGEMENT

Recent Investment Management Developments

April 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 management industry.

Proposed Changes to Taxation of Carried Interest

Although significant changes in the tax law in an election year are improbable, the nearly decade-long debate on the proper tax treatment of equity compensation paid to managers of hedge funds and private equity funds may be reaching something of a consensus.

Currently, compensation paid to fund providers as "carried interest" payable after certain performance hurdles are achieved is generally taxed at capital gains rates when realized rather than at ordinary income tax rates. Such tax treatment is quite favorable when compared to the taxation of bonuses paid to wage earners at ordinary income tax rates. Moreover, the receipt of "carried interest" by limited partners in hedge and private equity funds is generally not subject to self-employment tax, while bonuses paid to service providers that are employees are subject to Social Security taxes.

The Obama administration's recent budget and revenue proposals would generally tax the "carried interest" amounts at ordinary income tax rates when realized and also subject them to self-employment tax without regard to a provider's status as a limited partner. However, the administration has also announced that it remains "committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the [holder of the 'carried interest']," suggesting that it is willing to negotiate the percentage of the "carried interest" that may be recharacterized.

On the Republican side, the Chairman of the House Ways and Means Committee, U.S. Rep. David Camp (R-MI), has released a draft of the Tax Reform Act of 2014 containing a similar proposal to recharacterize "carried interest" amounts when realized as ordinary income. The Camp proposal limits the amounts to be recharacterized to a cumulative "recharacterization account" that is to be annually redetermined under a complex formula, perhaps as an opening bid for future negotiations with the administration. Rep. Camp's draft would generally include a fixed percentage of a "carried interest" in the self-employment tax base where the limited partner was a "material participant" in the partnership's business.

Although neither proposal is likely to be adopted this year, the inclusion of a change in the taxation of "carried interest" in a Republican tax reform proposal suggests that it will be "on the table" in 2015 budget and revenue negotiations.

SEC Fines One Adviser and Charges Another Defendant over Social Media Misuse; SEC Issues Guidance on the "Testimonial Rule"

The Securities and Exchange Commission (SEC) settled a claim earlier this year 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 using Twitter. The regulator's message: social media statements are no different from any other statements and carry the same risks and restrictions. Mr. Grimaldi paid a $100,000 fine.

On April 8, 2014, the SEC announced that it had brought fraud charges against a Honolulu resident, Keiko Karamura, who had engaged in two separate schemes that ultimately defrauded investors out of more than $200,000.

Initially, Ms. Karamura set up a fake hedge fund and posted about it through social media websites such as Twitter. Her posts included account statements that belonged to a different hedge fund. All investments that were made towards Ms. Karamura's fabricated hedge fund inured to her benefit. In another alleged scheme, Ms. Karamura used social media websites to boast about investment experience that she did not actually possess and induced investors to pay for her investment advice services.

In March 2014, perhaps motivated by the aforementioned cases, the SEC issued guidance[1] regarding whether the publication of comments made about investment advisers on social media sites would violate Rule 206(4)-1(a)(1) (the "testimonial rule[2]) or Rule 206(4)-1(a)(5), each promulgated under the Investment Advisers Act of 1940 (collectively, the Rules).

Section 206(4) and the Rules govern fraudulent communications by registered investment advisors (RIAs). The new SEC guidance instructs RIAs to apply the spirit of this section and the Rules to their social media communications. The new guidance provides that:

- Publishing clients' experiences on the RIA's own website, or on the RIA's social media site, is prohibited as a testimonial.
- Social media sites that include a listing of contacts or "friends" will generally not be considered a testimonial or endorsement of the RIA, unless the RIA attempts to infer that such friends have experienced favorable results as clients.
- Directing clients to social media services owned or operated by the RIA is not deemed to be soliciting testimonials from clients.
- Communications by third-party websites or content producers who are independent, i.e., have "no material connection" to the RIA, are not prohibited testimonials.

RIAs likely will have to conduct additional monitoring and adopt new policies and procedures to ensure compliance with the updated guidance. They must weigh their obligation to comply with these conditions against the benefit of using social media commentary in advertisements.

Trend: Advisers Attacked for Overcharges on Subadvised Funds

In the first quarter of 2014, mutual fund shareholders continued to use Section 36(b) of the Investment Company Act of 1940 (the 1940 Act) to sue certain investment advisers that subcontract advisory functions to a subadviser. Section 36(b) imposes a fiduciary duty on an investment adviser related to compensation received from funds. Under Section 36(b), shareholders have a right to recover excessive fees on behalf of the fund.

In March 2014, a plaintiff filed a complaint on behalf of the BlackRock Global Allocation Fund against BlackRock Advisors, the principal investment adviser to the fund.[3] In February 2014, other plaintiffs filed a complaint, also on behalf of the fund, against BlackRock Advisors, as well as against a former subadviser, and the current subadviser, both of which are BlackRock affiliates.[4] The plaintiff in the March complaint alleged that, in 2013, the principal BlackRock adviser retained almost 43 percent of investment management fees, despite doing little work for the fund. The plaintiffs in the February 2014 complaint alleged that the fund was potentially paying more than twice what BlackRock charged other funds for subadvisory services outside of the BlackRock fund complex. The plaintiffs in both complaints also allege that adviser did not sufficiently share economies of scale with the fund by reducing fees as the fund grew. Additionally, the plaintiffs allege that fund's board failed to protect the fund and its shareholder, and did not independently and conscientiously negotiate arm's-length fees with the adviser.

Similar to the plaintiffs in these two suits against BlackRock, shareholders in February 2014 sued Harbor Capital Advisors over amounts being paid in relation to advisory fees paid by the Harbor International Fund.[5] The plaintiff alleged that the subadviser, Northern Cross, was doing substantially all of the work, but that Harbor Capital Advisors was nonetheless retaining about $100.5 million out of the more than $225 million the fund paid in investment management fees in 2012.

Despite the rise in suits alleging that advisers are receiving excessive fees from subadvised funds, the plaintiffs will have to overcome a high bar to prevail on their claims. They will have to prove that the defendant investment adviser charged a fee that is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[6]

Following *Janus Capital Group* Holding, Second Circuit Declines To Find Rule 10b-5 Liability

In *Fezzani v. Bear, Stearns & Co. Inc.*,[7] the Second Circuit held that a defendant was not liable, in a private claim for damages, for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated under that section, even though the defendant had facilitated the alleged fraud. The court came to this conclusion because the plaintiff did not allege that the defendant communicated the artificial price information to the would-be buyers. The court found this fact relevant in light of, among other precedents, the U.S. Supreme Court's decision in *Janus Capital Group Inc. v. First Derivative Traders*, 131 S.Ct. 2296 (2011). In *Janus,* the Supreme Court held that defendant cannot be held primarily liable in a Rule 10b-5(b) private securities action for "making" a misleading statement or omission unless the defendant had ultimate authority over the statement's content and whether and how to communicate it.[8] The Second Circuit's decision in *Fezzani* is one of a number of decisions by courts that, applying the *Janus* decision, declined to impose liability on third parties who did not actually make allegedly misleading statements.

SEC's Champ Outlines Investment Management Staff Priorities

Norm Champ, the Director of the Division of Investment Management of the SEC, identified the priorities of the SEC's Investment Management Staff in a speech to industry professionals in March 2014 as follows:

1. Complete the pending money market fund proposal.

2. Complete analyzing comments on the proposed rule regarding general solicitation and advertising.

3. Revise Form N-SAR (and related securities holdings disclosure).

4. Reform variable annuity disclosures.

5. Reform disclosures on target date funds.

6. Complete congressional mandates relating to the deletion of credit ratings references.

7. Review distribution fees and practices after consultation with the Office of Compliance, Inspections, and Examinations.

8. Propose a rule for investment advisers' obligations to report on "say-on-pay" votes.

SEC Focuses Independent Fund Trustees on Audit Quality

Paul Beswick, the chief accountant of the SEC, recently urged fund audit committees to focus on audit quality rather than price. According to Mr. Beswick, "[I]f the audit committee is solely fee hunting and if there was a subsequent audit failure, beyond the obvious problems for the auditor and the company, this may raise questions about the diligence of the members of the audit committee in fulfilling their responsibilities."

Mr. Beswick voices his concerns immediately after the Public Company Accounting Oversight Board (PCAOB) issued a report that was critical of the adequacy of current auditor reviews. The report noted that the audits were generally deficient due to the fact that the audit committees and other designated company reviewers were failing properly to assess independent audits. As a result, the report concluded that "[o]bservations from the Board's 2012 inspections indicated that audit deficiencies and the related deficiencies in engagement quality reviews continued to be high."

In late February, the Practising Law Institute hosted its two-day "SEC Speaks in 2014" Conference. One of the major focal points of the conference was how to improve the quality of independent auditor reports of public companies. The conference leaders concluded that audit committees are in the position to improve the process by doing adequate and meaningful reviews of their companies' independent audit reports.

SEC's Guidance on Unbundling of Proxy Proposals

Rule 14a-4(a)(3) promulgated under the Exchange Act concerns the "unbundling" of separate matters that are submitted to a shareholder vote by a company or any other person soliciting proxy authority. Recently, the staff of the SEC Division of Corporation Finance issued three Compliance and Disclosure Interpretations providing guidance on the unbundling of proxy proposals. In each of these interpretations, the SEC staff furnished examples under which the staff believes it is permissible for a registrant to combine multiple matters into a single proposal.

Multiple matters that are so "inextricably intertwined" that they effectively constitute a single matter need not be unbundled. The first interpretation discussed when management of a registrant has negotiated concessions from holders of a series of its preferred stock to reduce the dividend rate on the preferred stock in exchange for an extension of the maturity date. The SEC staff stated that the proposal need not be unbundled because it involved multiple matters so "inextricable intertwined" as to effectively constitute a single matter. The SEC staff viewed the matters relating to the terms of the preferred stock as being inextricably intertwined because each of the proposed provisions related to a basic financial term of the same series of capital stock and was the sole consideration for the countervailing provision.

A single "material" matter may be presented with a number of "immaterial" matters. When management of a registrant intends to present an amended and restated charter to shareholders for approval at an annual meeting, and the proposed amendments would change the par value of the common stock, eliminate provisions relating to a series of preferred stock that is no longer outstanding and not subject to further issuance, and declassify the board of directors, the SEC staff has said that the multiple proposals need not be unbundled. The SEC staff would not ordinarily object to the bundling of any number of immaterial matters with a single material matter. While there is not bright-line test for determining materiality within the context of Rule 14a-4(a)(3), registrants should consider whether the given matter substantively affects shareholder rights.

Multiple amendments to equity incentive plan may be presented as one matter. Although the SEC staff generally will object to the bundling of multiple, material matters into a single proposal—provided that the individual matters would require shareholder approval under state law, the rules of a national securities exchange, or the registrant's organizational documents if presented on a stand alone basis—the SEC staff will not object to the presentation of multiple changes to an equity incentive plan in a single proposal. This is the case even if the changes can be characterized as material in the context of the equity incentive plan and the rules of a national securities exchange would require shareholder approval of each of the changes if presented on a standalone basis.

MSRB Proposes Municipal Advisory Supervision Role

In February 2014, the Municipal Securities Rulemaking Board (MSRB) issued a request for comment on a supervision rule for municipal advisors, draft Rule G-44. The proposed rule contains similar concepts to Rule G-27, the MSRB's existing supervision rule for broker-dealers.

Under draft Rule G-44, municipal advisors must establish, implement, and maintain a supervisory system reasonably designed to ensure compliance with applicable laws, rules, and regulations. The supervisory system must include:

- Written supervisory procedures that can quickly adapt to regulatory changes and that consider the municipal advisor's size, organizational structure, nature and scope of municipal advisory activities, number of offices, the disciplinary and legal history of its associated persons, the outside business activities of its associated persons, and "red flags" identifying potential irregularities or misconduct

- The designation of at least one municipal advisory principal—with sufficient knowledge, expertise, and training—responsible for supervision

In addition, draft Rule G-44 requires a municipal advisor to have in place a compliance process by which it can review, test, and modify its compliance policies and supervisory procedures. The municipal advisor must, at a minimum, review its policies and procedures annually.

Draft Rule G-44 requires the municipal advisor to designate an individual to serve as its chief compliance officer. The individual may be a principal of the firm or a non-employee.

The deadline for submitting comments regarding draft Rule G-44 is April 28, 2014. Municipal advisors will be subject to corresponding record-keeping requirements if the rule is adopted.

If adopted, draft Rule G-44 will be effective after the effective date for the MSRB's conduct rule for municipal advisors, draft Rule G-42. Following its board meeting earlier this month, the MSRB announced that it will also soon request comment on establishing a professional qualification test for municipal advisors. The MSRB will also seek approval from the SEC to assess municipal advisor firms a $300 annual fee, per professional, effective the second half of 2014 when the SEC's final municipal advisor registration rules take effect.

SEC Staff Issues Guidance Updates on S-X Rules 3-09 and 4-08(g) for Business Development Companies

The Division of Investment Management of the SEC released guidance regarding rules that require business development companies (BDCs) to include in their registration statements certain financial information about unconsolidated subsidiaries. [9] BDCs use Form N-2 to register their securities under the Securities Act of 1933, as amended (the "Securities Act"). The main purpose of the guidance by the SEC staff was to point out that Rules 3-09 and 4-08(g) of Regulation S-X do apply to a BDC's Form N-2. Rule 3-09 addresses, among other things, "the circumstances under which separate financial statements of an unconsolidated majority-owned subsidiary are required to be filed." Rule 4-08(g) generally requires BDCs to "present in the notes to their financial statements summarized financial information for all unconsolidated subsidiaries when any unconsolidated subsidiary, or combination of unconsolidated subsidiaries, meets the definition of a 'significant subsidiary.'" Regulation S-X Rule 1-02(w) defines "significant subsidiary."

The staff observed that some BDCs had been failing to provide separate financial statements or summarized financial information for subsidiaries when Rule 3-09 or Rule 4-08(g) actually required such financial statements or information. The staff also stated that it "would not object" if a BDC required to present summarized financial information in the notes to its financial statements, according to Rule 4-08(g), presents only summarized financial information for each unconsolidated subsidiary that individually meets the definition of "significant subsidiary," rather than presenting summarized financial information for all of the BDC's unconsolidated subsidiaries. Additionally, the SEC staff noted that if a BDC believes that complying with Rule 3-09 or Rule 4-08(g) would result in the presentation of either separate financial statements or summarized financial information of an unconsolidated subsidiary that is not reasonably necessary to inform investors, the BDC should contact the Chief Accountant's Office of the SEC's Division of Investment Management.

SEC Delays Implementation of Municipal Advisor Registration Rules

In September 2013, the Securities and Exchange Commission (SEC) voted to adopt a final rule establishing a permanent registration regime for municipal advisors. Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), municipal advisors were not required to register with the SEC. Section 975 of Dodd-Frank made it unlawful, however, for any municipal advisor 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 advisors 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 advisor 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.[10] 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 substantially. 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.

Although many commentators believe the staff's analysis to have merit, the release has also produced two criticisms. First, many commentators believe that the mid-2013 spike in open market interest rates resulted from a confluence of factors – not just a reduction in dealer bond inventories relative to market size. For example, interest rates were almost certainly affected by the 2013 brinkmanship over the U.S. government's debt ceiling, coupled with a three-week federal government shutdown, the expected reduction in open market bond purchases by the Federal Reserve, and the threatened U.S. government securities default in October. 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.[11]

Second, some commentators have criticized the SEC for engaging in what is tantamount to rule making - - establishing a *de facto* standard on disclosure without going through the traditional proposal and comment process. By doing so, detractors believe the SEC not only exceeded its authority, but also lost the substantial benefit of industry experience reflected in the comment process.

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),[12] 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 Advisers Act.[13] 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.

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.[14] 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 Exchange Act 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.[15] Under the "misappropriation theory," a corporate outsider 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."[16] 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."[17]

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." [18] 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.

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.[19]

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.

[1] Guidance on the Testimonial Rule and Social Media, IM Guidance Update 2014-4 (March 2014), http://www.sec.gov/investment/im-guidance-2014-04.pdf

[2] Rule 206(4)-1(a)(l) promulgated under the Investment Advisers Act of 1940.

[3] Complaint, *Foote v. BlackRock Advisors, LLC*, 3:14-cv-01991 (D.N.J. filed Mar. 28, 2014).

[4] Complaint, *Clancy v. BlackRock Investment Management, LLC*, 3:14-cv-01165 (D.N.J. filed Feb. 21, 2014).

[5] Complaint, *Zehrer v. Harbor Capital Advisors, Inc.*, 1:14-cv-00789 (N.D. Ill. filed Feb. 4, 2014).

[6] *See Jones v. Harris Assocs., L.P.*, 559 U.S. 335, 345-46 (2010).

[7] 716 F.3d 18 (2d Cir. 2013).

[8] 131 S.Ct. at 2307.

[9] Div. of Inv. Mgmt., Sec. & Exch. Comm'n, *Business Development Companies – Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries*, Guidance Update No. 2013-07 (Sept. 2013).

[10] 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.

[11] 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.

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

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

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

[15] *Chiarella v. United States*, 445 U.S. 222 (1980).

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

[17] *Id*.

[18] 723 F. 3d at 772.

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