Ballard Spahr LLP

INVESTMENT MANAGEMENT

Recent Investment Management Developments

July 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.

SEC Scrutinizes Annual Advisory Agreement Renewal Process

In July 2014, the SEC settled the previously reported proceeding involving Chariot Advisors, and its former owner, Elliott Shifman, concerning charges of violating and aiding and abetting the violation of Section 15(c) of the 1940 Act.[1]

The SEC found that, in communications during the 15(c) process for a proposed fund, Chariot Advisors lied to the board of The Northern Lights Funds about Chariot's ability to run an algorithmic currency trading strategy. The SEC found that 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's findings, however, Chariot Advisors did not possess any algorithms for conducting currency trading.

The SEC order points out that the ability to conduct currency trading for the Chariot Fund was particularly significant because the fund was just being formed and, in the absence of a 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. As a result of the conduct described above, the SEC found that Chariot Advisors violated Section 15(c), and that Shifman caused this violation.

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 the Matter of Chariot Advisors, LLC,* the SEC examined the various disclosures made to the board during the 15(c) process.

Chariot Advisors is at least the fourth enforcement case brought by the SEC's specialized asset management unit as part of its compliance sweep relating to the requirement that fund boards evaluate their agreements with investment advisers. The proceeding also follows a 2013 investigation involving the Northern Lights Funds, in which gatekeepers of the Northern Lights Fund Trust and the Northern Lights Variable Trust settled allegations that they caused false or misleading disclosures about what they considered in approving or renewing investment advisory contracts.

As a result of the proceeding, Shifman was suspended from association with virtually any entity in the securities industry for a period of 12 months and ordered to pay a $50,000 fine.

Although the Chariot Advisors proceeding did not directly implicate the fund board, the action underscores the SEC's continuing intent to scrutinize the entire 15(c) process and, by implication, warns fund boards to be diligent in their adherence to their 15(c) duties.

Third Circuit Considers Whether 401(k) Recordkeepers are Fiduciaries

The Third Circuit is considering whether a 401(k) recordkeeper is deemed to be a fiduciary under ERISA.[2] The plaintiffs in *Santomenno v. John Hancock* alleged that John Hancock acted as a functional fiduciary and breached its fiduciary duty when it charged the trustees of the plaintiffs' 401(k) plan with what they alleged were excessive fees. The lower court held that John Hancock was not a functional fiduciary under ERISA.[3] In reaching its holding, the court relied on *Renfro v. Unisys Corp.*,[4] which held that a service provider "owes no fiduciary duty with respect to the negotiation of its fee[s]."[5] The trial court then explained that John Hancock fully disclosed and negotiated the service provider fees and the trustees had the final say over their plan, and they were free to find a different 401(k) service provider if they felt John Hancock's fees were too expensive.[6]

The plaintiffs appealed the decision to the Third Circuit Court of Appeals, which heard argument in June 2014.

The plaintiff-appellants asserted that 29 U.S.C. 1002(21)(a) included three ways by which an entity could be a fiduciary. First, they argued that John Hancock was a fiduciary because John Hancock provided "client and plan specific" investment advice (subsection (ii)). The evidence for this proposition was a John Hancock brochure that was mailed to all trustees containing the statement that John Hancock served its clients with "plan specific" investment options.

Next, the plaintiffs argued that under 29 U.S.C. 1002 (21) (a) subsection (i), John Hancock exercised discretionary authority over the management of the plan when it imposed its fees unilaterally. They alleged that there was no mention of service provider fees in the negotiation of the contract between John Hancock and the trustees and, therefore, John Hancock imposed those fees unilaterally.

When questioned by the panel regarding *Renfro* and who had the final say in terms of investment options, the plaintiff-appellants argued that John Hancock, not the trustees, had the final say, thereby making John Hancock a fiduciary under subsection (iii) of 29 U.S.C. 1002 (21) (a). The plaintiffs asserted that unlike *Renfro*, where the trustee was able to seek out other 401(k) providers, the trustees did not have the final say over their investment options because John Hancock was the only service provider made available to facilitate their 401(k) plan. Plaintiff-appellants argued that because John Hancock was the plan's sole service provider, the trustees were unable to seek out a different provider in the event of a rejection of John Hancock's service fees and/or investment options and therefore, the trustees did not retain the final say.

The U.S. Department of Labor (DOL) submitted an amicus brief in support of the plaintiff-appellants' position. DOL argued that John Hancock acted as a fiduciary under subsections (i) and (ii) of 29 U.S.C. 1002 (21) (a). DOL alleged that John Hancock unilaterally set its service fee by retaining and

exercising the power to charge up to a 1 percent fee and could change the fee without notifying the trustees. DOL explained that John Hancock engaged in ongoing monitoring of the plan and had the discretionary authority to make such changes and used this authority to make substitutions to the "Big Menu"[7] of investment options.

Further, DOL argued that although *Renfro* made clear that a service provider owes no fiduciary duty in the negotiation of its fees, John Hancock did not negotiate or disclose its fees to the trustees. Because there was no negotiation, John Hancock owed a fiduciary duty to the trustees in disclosing its fees.

In concluding its argument, DOL acknowledged that the key in fiduciary cases is who has the final say over the plan. DOL argued that John Hancock retained the power to make changes to the plan, and if the trustees were unhappy with those changes, their only recourse was to cancel their plan and incur a termination fee. Therefore, John Hancock retained the final say and assumed fiduciary status.

Before the Third Circuit panel, John Hancock offered the following arguments. First, John Hancock argued that under subsection (ii) of 29 U.S.C. 1002 (21) (a), it did not provide investment advice; it simply provided mutual fund investment options, and the trustee could select a fund in which to invest. John Hancock also pointed out that although the plaintiff-appellants claim that John Hancock provided investment advice, DOL did not make this argument. John Hancock then pointed to the contract between John Hancock and the trustees which states, in effect, that John Hancock does not provide investment advice as it will not be assuming any responsibility or fiduciary obligations.

In responding to the allegation that it imposed its service fees unilaterally, John Hancock argued that every recordkeeper or service provider charges service fees for its work and those fees are known to the trustee at the time of selection. Therefore, the trustees knew about the service fee. John Hancock also explained that the 401(k) service provider industry is competitive, and every provider charges a service fee; thus, service provider fees are typical.

John Hancock then spoke about which party retained the final say and explained that nothing in the contract stated that the trustee could not go to a different service provider. More specifically, John Hancock argued that the contract specifically allows the trustee to go outside the plan with John Hancock and to use outside funds for 401(k) investment purposes; thereby giving the trustee the final say over the management of their plan. Contrary to the DOL claim, John Hancock made clear that there was no termination fee and thus, no obstacle standing in the way of the trustee's ability to find a different service provider.

John Hancock then emphasized that the plaintiffs have offered nothing more than conclusory statements that do not satisfy the standards of a well-pleaded complaint. Moreover, John Hancock argued that the record failed to show that the trustees' authority over their plan was usurped by John Hancock or that John Hancock hid any of its fees from the trustees.

The large majority of cases to have considered this question have held that the recordkeeper is not an ERISA fiduciary.[8] However, any decisions are fact-specific. If a recordkeeper is routinely deemed to be a fiduciary, the existing equilibrium in the 401(k) space may be upended until this new fact can be properly taken into account in fee setting, contract negotiation, etc.

Municipal Advisor Registration Deadline Imminent

Municipal advisors are required to register with the SEC and the Municipal Securities Rulemaking Board (MSRB) under Section 975 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and SEC rules. The registration deadline depends on the date of registration by the municipal advisor under expiring temporary rules. The earliest registration deadline is July 31, 2014.

Supreme Court Allows Anti-Retaliation Suits by Fund Service Providers' Employees

The U.S. Supreme Court has ruled that the anti-retaliation provision of the Sarbanes-Oxley Act of 2002[9] (Sarbanes-Oxley) protects employees of investment advisers and other service providers to mutual funds, and other public companies that engage in whistleblowing.[10] In prior decisions, lower courts had reached differing conclusions. The case came from the U.S. Court of Appeals for the First Circuit, which had ruled that the applicable provision protects only employees of the public company (or mutual fund) itself. The Supreme Court decision allows employees of contractors and subcontractors to public companies to seek reinstatement and compensation if they are discharged or discriminated against for providing information concerning shareholder fraud, certain criminal frauds, or violations of SEC rules to federal regulatory or law enforcement agencies or through internal channels.

Sarbanes-Oxley provides that no public company or any officer, employee, contractor, subcontractor, or agent of such company may retaliate against "an employee." Courts had been divided on whether the "employee" must be an employee of the public company, or could be an employee of the contractor or subcontractor.

The Court concluded that the statutory text, purposes, and history show that the provision covers employees of private contractors and subcontractors, just as it covers employees of the public company – in this case, a mutual fund served by them. The Court was unpersuaded by the argument that mutual funds and investment advisers are separately regulated under the Investment Company Act of 1940 (1940 Act) and observed that, because mutual funds had no employees of their own, Sarbanes-Oxley would offer no protection for whistleblowing about operations of the funds if the appellee's legal position were sustained.

EU Court of Justice Ruling May Allow U.S. Funds To Obtain Tax Refunds

The Court of Justice of the European Union (EU) has ruled that a non-EU investment fund may be able to obtain the same tax exemption available to funds established in an EU member state. The case arose in Poland, where domestic and EU investment funds are exempt from tax, but non-EU funds are subject to tax on the dividend income they receive. A U.S. mutual fund sought a tax refund, arguing that the disparate treatment was in violation of a provision of the Treaty on the Functioning of the European Union (TFEU), which prohibits restrictions on the movement of capital between member states and third countries.

The Court of Justice ruled that the TFEU prohibits the enactment of tax laws of a member state that make dividends payable to a non-EU investment fund ineligible for the applicable tax exemption if the member state and non-member state are bound by an obligation of mutual administrative assistance that enables the national tax authorities to verify information transmitted by the investment fund. The Court of Justice referred the case back to the Polish court for a determination whether the U.S.-Poland tax treaty meets this standard. The principles of the ruling, which apply across the EU, not just to Poland, could lead to large refunds for U.S. funds.

SEC, Other Regulators Pursue Puerto Rico Bond Inquiries

In the third quarter of 2013, the SEC canvassed several mutual fund companies, asking for information about their funds' exposure to municipal bonds issued by the Commonwealth of Puerto Rico, the trading of Puerto Rico debt among accounts and funds, and communications with shareholders about Puerto Rico.[11] The SEC sent these requests while the island's credit ratings verged on "junk" status.

In February 2014, Puerto Rico lost its investment-grade credit ratings. Yet, in March 2014, a $3.5 billion sale of Puerto Rico high-yield bonds was oversubscribed.[12] Mutual funds that typically do not focus on municipal bonds were among the buyers of

Puerto Rico's high-yield bonds.[13] The demand for these bonds may have signaled an improvement in investor sentiment about higher-yield municipal bonds. The demand may have also been the result of the lack of yield across the financial markets.

Just a week after Puerto Rico's $3.5 billion bond sale, the Financial Industry Regulatory Authority (FINRA) announced that it was examining trading in the island's bond issue.[14] FINRA's examination arose from concerns that these Puerto Rico bonds were being sold to individual investors, based on the relatively small amounts in which some market participants were completing trades in the bonds.[15]

In May 2014, plaintiffs in the Southern District of New York sought class-action status for their suit against UBS AG and Popular Inc. (the parent of Banco Popular) concerning failed investments in closed-end mutual funds that invested in Puerto Rico bonds.[16] According to the plaintiffs, UBS and Popular underwrote Puerto Rico bonds, served as investment advisers to the funds buying the bonds, and earned commissions from investors who bought shares of the funds through the bank's retail brokerage units. The plaintiffs also alleged that UBS used leverage in the funds, and encouraged investors to borrow $500 million to further their investments in the funds.[17]

The U.S. Treasury Department has formed a new unit to monitor the municipal bond market. [18] Kent Hiteshew will lead the Treasury's new effort to monitor the municipal bond market more closely. Puerto Rico's fiscal difficulties in particular have been drawing attention of regulators because a default by Puerto Rico on its bonds could have significant implications for the rest of the municipal bond market. Approximately three fourths of municipal bond funds own debt issued by Puerto Rico.[19]

Investment Adviser Charged with Breaching Fiduciary Duties and Misleading Investors

In April 2014, the SEC charged Total Wealth Management, Inc. (Total Wealth) – as well as its chief executive officer, chief compliance officer, and another employee – with violations of the securities laws.[20] The SEC alleged that Total Wealth and its CEO and owner, Jacob Keith Cooper, created a conflict of interest by paying themselves undisclosed "revenue sharing fees" derived from investments they recommended to investors and misrepresented the extent of the due diligence they had conducted on investments they recommended. The SEC also alleged that Total Wealth's chief compliance officer, Nathan McNamee, and Total Wealth representative Douglas David Shoemaker breached fiduciary duties they owed to clients, and defrauded clients, by not disclosing relevant conflicts of interest and by concealing the revenue sharing fees, which the SEC described as "kickbacks."[21] Cooper, McNamee, and Shoemaker each allegedly created an entity to receive the revenue sharing fees and to hide the fact that they were the ultimate recipients of these payments. As described in the SEC's order, the revenue sharing fees were not apparent to investors, and Total Wealth paid these fees to the controlled entities for "consulting" work, even though the other entities provided no consulting services. The alleged misconduct occurred in connection with investments in unregistered funds in the Altus family of funds. Total Wealth was also the owner and managing member of Altus Management, the general partner of the Altus funds.

The SEC charged, among other things:

- Total Wealth and Cooper, McNamee, and Shoemaker with violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder, and Section 207 of the Advisers Act, all of which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities

- Total Wealth and Mr. Cooper with breaching fiduciary duties in violation of Sections 206(1), 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 promulgated thereunder

The remedial actions that the SEC may seek could include financial penalties, disgorgement, and cease and desist orders.

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 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[22] 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[23]) or Rule 206(4)-1(a)(5), each promulgated under the Advisers Act (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 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.[24] 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.[25] 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 the adviser did not sufficiently share economies of scale with the fund by reducing fees as the fund grew. Additionally, the plaintiffs allege that the 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.[26] 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."[27]

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

In *Fezzani v. Bear, Stearns & Co. Inc.*,[28] 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.[29] 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 no 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 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 was 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.[30] 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 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.[31] 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.[32]

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

In April, 2014 the Public Company Accounting Oversight Board (PCAOB) held a public meeting to further the discussion and evaluation of its 2013 proposal[33] 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),[34] 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.

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.[35] 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.[36] 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."[37] 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."[38]

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." [39] 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.

[1] *In re Chariot Advisors, LLC*, Admin. Proc. No. 3-15433, Investment Company Act Release No. 31149 (July 3, 2014).

[2] 29 U.S.C. § 1001.

[3] 2:10-CV-01655 WJM, 2013 WL 3864395 (D.N.J. July 24, 2013).

[4] 671 F.3d 314 (3d Cir. 2011).

[5] Id. at *7.

[6] Id.

[7] The "Big Menu" of investment options refers to the list of all mutual funds that the service provider or recordkeeper originally presents to the trustee as options for the plan's investors. From that menu, the trustee selects the mutual funds to be offered by the plan; that subset makes up the trustee's "Small Menu."

[8] See, e.g., *Hecker v. Deere & Co.*, 556 F.3d 575 (7th Cir. 2009) and *Leimbuehler v. Amer. United Life Ins. Co.*, 713 F.3d 905 (7th Cir. 2013); but see, *Golden Star, Inc. v. Mass Mut. Life Ins. Co.* CIV. 3:11-30235-PBS, 2014 WL 2117511 (D.Mass. May 20, 2014).

[9] 116 Stat. 745.

[10] *Lawson v. FMR LLC*, No. 12-3, slip op. (U.S. Mar. 4, 2014).

[11] Andrew Ackerman & Kelly Nolan, *SEC Canvasses Fund Companies on Puerto Rico Debt*, Wall St. J., Oct. 24, 2013.

[12] Maureen Nevin Duffy, *Muni Bonds Pose Questions for Advisors*, Financial Advisor Magazine, May 2014, 73.

[13] Joe Morris, *Puerto Rico Beckons Beyond Muni Bond World*, Ignites, May 19, 2014, http://ignites.com/pc/891044/85254.

[14] Mike Cherney & Al Yoon, *FINRA Examining Trading in Puerto Rico Bonds*, Wall St. J., Mar. 21, 2014.

[15] *Id.*

[16] Matthias Rieker, *UBS, Popular Sued Over Losses in Puerto Rico Bond Funds*, Wall St. J., May 7, 2014.

[17] Joe Morris, *UBS Sued Over Puerto Rico Fund Losses*, Ignites, May 7, 2014, http://www.ignites.com/pc/883674/84114.

[18] Andrew Ackerman, *Treasury Turns Its Gaze to Municipal-Bond Market*, Wall St. J., Apr. 16, 2014.

[19] *Id.*

[20] *In re Total Wealth Management, Inc.*, File No. 3-15842 (Sec. & Exch. Comm'n Apr. 15, 2014), http://www.sec.gov/litigation/admin/2014/33-9575.pdf.

[21] Sec. & Exch. Comm'n, *SEC Charges San Diego-Based Investment Adviser* (Apr. 15, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541502917.

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

[23] Rule 206(4)-1(a)(l) promulgated under the Advisers Act.

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

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

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

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

[28] 716 F.3d 18 (2d Cir. 2013).

[29] 131 S.Ct. at 2307.

[30] 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).

[31] *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.

[32] 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.

[33] Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments.

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

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

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

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

[38] *Id*.

[39] 723 F. 3d at 772.