Investment Services Regulatory Update

November 1, 2010

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Proposes Rule on Institutional Investment Manager Reporting of Proxy Votes on Executive Compensation

On October 18, 2010, the SEC proposed Rule 14Ad-1 under the Exchange Act, which would require institutional investment managers subject to Section 13(f) of the Exchange Act (i.e., advisers with discretionary authority over accounts holding equity securities with an aggregate fair market value of at least $100 million) to report how they vote proxies on, among other things, executive compensation matters. Specifically, proposed Rule 14Ad-1, if adopted, would require institutional investment managers to disclose annually on Form N-PX how they voted on so-called "say-on-pay" and related matters proposed by companies over which the institutional investment managers have voting authority.

To assist in the implementation of proposed Rule 14Ad-1 and to provide clarity to the reporting requirements, the SEC also proposed certain amendments to Form N-PX, which is currently only used by registered funds. The proposed amendments to the Form are meant to accommodate reporting by institutional investment managers. Among other things, Form N-PX would be amended to include a new summary page intended to enable users to identify any institutional investment manager (in addition to the person filing the report) whose say-on-pay votes are included in the report, and those institutional investment managers whose say-on-pay votes are not included in the Form. These new requirements would also apply to the proxy voting reporting by registered funds.

While information filed on Form N-PX is publicly available under the proposal, an institutional investment manager could request confidential treatment of information reported on the Form.

Comments on the proposals are due by November 18, 2010.

FinCEN Extends Compliance Date for AML Travel Rule for Mutual Funds

On October 15, 2010, FinCEN issued a final rule extending the date by which mutual funds must comply the "Travel Rule" from January 10, 2011 to April 10, 2011. FinCEN extended the compliance date to provide mutual funds with an opportunity to implement changes to their transaction reporting and record keeping systems. The Travel Rule requires financial institutions, including mutual funds, to create and retain records for transmittal of funds and transmit information on these transactions to other financial institutions in the payment chain. Since mutual funds would be excepted from most of the Travel Rule's requirements, the effect of the Rule is that mutual funds would need to create and retain records for extensions of credit and cross-border transfers of currency, monetary instruments, checks, investment securities and credit for transactions exceeding $10,000.

SEC Proposes Rule Defining "Family Office" Adviser

On October 12, 2010, in its first step towards implementing the provisions of Section 409 of the Dodd-Frank Act, the SEC proposed new Rule 202(a)(11)(G)-1 under the Advisers Act defining the term "family office" for the purpose of excluding them from the definition of "investment adviser" in the Advisers Act, and thereby exempting them from registration as investment advisers under the Advisers Act.

Historically, family offices that would otherwise fall within the definition of investment adviser have relied on the "private adviser exemption" under Section 203(b) of the Advisers Act, which provides an exclusion for advisers with fewer than 15 clients that do not hold themselves out as investment advisers. Throughout the years, the SEC has also provided significant exemptive relief to family offices for which the private adviser exemption was unavailable. Effective July 21, 2011, the Dodd-Frank Act renders obsolete the private adviser exemption. The proposed Rule, if adopted, would effectively codify a substantial portion of the exemptive relief provided to family offices over the years.

Comments on the rule proposal are due by November 18, 2010.

SEC Stays Effectiveness of Amendments to Proxy Rules that Facilitate Rights of Shareholders to Nominate Directors

On October 4, 2010, the SEC ordered a stay of the effect of proxy rules adopted on August 25, 2010 that enhance the rights of shareholders to nominate directors for corporate boards, including boards of investment companies. The stay was granted in response to a petition by the Business Roundtable and the U.S. Chamber of Commerce pending resolution of court challenges to the rules that they filed on September 29, 2010 with the Court of Appeals for the District of Columbia Circuit.

The amendments create Rule 14a-11 under the Exchange Act, which allows eligible shareholders to have their nominees included in a company's proxy materials. Shareholders must meet all the requirements of Rule 14a-11 to have their nominee included in a company's proxy materials and Rule 14a-11 is not available if applicable state law or the company's governing documents prohibit shareholders from nominating candidates to the board. In addition, the amendments modify Rule 14a-8 under the Exchange Act to allow shareholders, subject to the other requirements of the Rule, to include proposals in a company's proxy materials that would amend provisions of a company's governing documents concerning the company's director nomination procedures or other director nomination disclosure provisions.

Pursuant to new Rule 14a-11, a shareholder is eligible to have a nominee included in a fund's proxy materials if the shareholder provides proper notice to the fund and, as of the date of such notice: (1) owns at least 3% of the outstanding fund voting securities entitled to vote on the election of directors at the meeting, (2) continuously held securities equaling the 3% threshold for at least three years prior to the notice date and (3) continues to hold the securities through the date of the shareholders meeting. Rule 14a-11 allows multiple shareholders to aggregate their individual holdings to meet the minimum ownership threshold, but each shareholder in the group must have held their qualifying shares for the required three-year period and must continues to hold their shares through the meeting date. For purposes of Rule 14a-11, unless a fund is a series company, a shareholder may determine the total amount of voting power of a fund's securities entitled to vote on the election of directors by reference to information included in the fund's most recent annual or semi-annual report on Form N-CSR. For a fund that is a series company, the fund must file a Form 8-K within four business days of setting a meeting date disclosing the total number of shares outstanding and entitled to vote on the election of directors as of the end of the most recent calendar quarter.

In addition to the ownership requirements, under Rule 14a-11, shareholders must certify that they are not holding their shares for the purpose of gaining control of the company or to gain more than a minority representation on the board of directors. An eligible shareholder is allowed to have one nominee or a number of nominees that would represent 25% of a company's board of directors, whichever is greater, included in the company's proxy materials. A nominating shareholder is required to file Schedule 14N with the SEC, which includes the information and certifications required by Rule 14a-11. A company that includes shareholder nominees in its proxy materials is not liable for any false or misleading statements in information provided by the nominating shareholder unless the company knows or has reason to know the information is false or misleading.

The amendments become effective on November 15, 2010, but their effectiveness is stayed pending resolution of the request for expedited review of the rules by the D.C. Court of Appeals.

SEC Amends Regulation FD as Required by the Dodd-Frank Act

On September 29, 2010, the SEC adopted an amendment to Regulation FD that became effective on October 4, 2010 and removed the exemption from public disclosure of material nonpublic information provided to nationally recognized statistical rating organizations (NRSROs) and credit rating agencies solely for the purpose of determining or monitoring a credit rating. The SEC amended Regulation FD to comply with a specific directive included in the Dodd-Frank Act that the exemption for information provided to NRSROs and credit rating agencies be removed.

CFTC Requests Comments on Amendments to Limit the Use of Futures by Investment Companies

On September 17, 2010, the CFTC issued a notice seeking comments on proposed amendments to CFTC Rule 4.5, which provides an exclusion from the term commodity pool operator for eligible persons operating certain qualifying entities, including registered funds. The proposed amendments would restore restrictions substantially similar to those in effect prior to 2003. Prior to 2003, persons seeking to fit within the exclusion were required to file a notice of eligibility and represent that the qualifying entity (1) has not marketed, and will not market, participations to the public as in a commodity pool or otherwise as a vehicle for trading commodity futures or commodity options and (2) will use commodity futures or commodity options contracts solely for bona fide hedging purposes and that the aggregate initial margin and premiums for speculative futures positions will not exceed 5% of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and losses on all such contracts. The amendments would also modify the limitation on speculative futures positions from former Rule 4.5 by referring directly to the qualifying entity claiming the exclusion. This could prohibit funds from trading futures and options on futures in wholly-owned subsidiaries, unless the subsidiary has also claimed an exemption under the Rule.

LEGISLATION

House Passes Regulated Investment Company Modernization Act of 2010

On September 28, 2010, the House of Representatives passed the Regulated Investment Company Modernization Act of 2010, which would amend the Internal Revenue Code to modify certain rules governing the taxation of regulated investment companies ("RICs"). Among other provisions, the Act would:

- permit RICs an unlimited carryforward of their net capital losses;
- allow income from commodities to be treated as qualifying income for purposes of the RIC gross income test;
- add savings provisions for failures of RICs to satisfy the RIC gross income and asset tests;
- modify the rules for designating and allocating RIC capital gain dividends;
- permit certain nondeductible items of income to be included in a RIC's earnings and profits calculations;
- allow qualified funds-of-funds to pass through to their shareholders tax-exempt interest and foreign tax credits, without regard to certain investment limitations;
- modify the rules relating to spillover dividends, return of capital distributions and stock redemptions;
- repeal the preferential dividend rule for publicly offered RICs;

- permit RICs to defer certain late-year losses; and
- modify certain excise tax and penalty rules applicable to RICs.

Congress Passes Legislation Limiting Confidentiality Protection for Materials Provided to the SEC

In September 2010, the Senate and House of Representatives each passed legislation amidst criticism that Section 929I of the Dodd-Frank Act undermines the goal of enhancing transparency and accountability in the financial system. As adopted, Section 929I modified the 1940 Act and the Advisers Act to generally provide that, with certain exceptions, the SEC shall not be compelled by a request under the Freedom of Information Act ("FOIA") to disclose any records or information it obtained in connection with its examination and surveillance efforts. The SEC had contended that such confidentiality provisions were necessary as regulated entities have refused to provide certain requested information that may not be protected by a FOIA exemption. The SEC's position failed to sway Congress and, as drafted, the current version of the legislation removes the confidentiality provisions in their entirety from the Acts.

Whistleblower Provisions Under the Dodd-Frank Act

Similar to the Sarbanes-Oxley Act, the Dodd-Frank Act includes whistleblower protections and remedial provisions for employees who suffer retaliation in connection with whistleblower actions. Unlike Sarbanes-Oxley, however, the Dodd-Frank Act does not limit such protection to employees of publicly-traded companies and provides for a private right of action in connection with a whistleblower claim.

The Dodd-Frank Act also creates incentives for securities whistleblowers. Specifically, a whistleblower, subject to certain limitations, is eligible to receive between 10% and 30% of the amount collected by the SEC in connection with any judicial or administrative action based on information provided by the whistleblower that results in monetary sanctions exceeding $1 million. The whistleblower award program provides that a whistleblower may provide such information anonymously. However, if a whistleblower both provides the information and makes a claim under the award program anonymously, the whistleblower must be represented by counsel. This requirement reportedly has resulted in increased whistleblower tips to plaintiffs' attorneys, which may be a direct result of increased attorney advertising. Of the more notable reported advertisements, a firm in New York City has begun advertising their whistleblower services in movie theaters, in particular, prior to the showing of the movie "Wall Street: Money Never Sleeps."

LITIGATION

Funds Face Lawsuits Over Payments to Distributors; California Court Dismisses First Case

During 2010, several lawsuits have challenged payments made to broker-dealers which are not also registered as investment advisers in connection with the distribution of fund shares. The lawsuits, which are derivative actions on behalf of the funds, allege payment of asset-based compensation to broker-dealers holding fund shares in brokerage accounts. The claims are based on the March 30, 2007 decision in *Financial Planning Association v. SEC*, in which the D.C. Circuit Court of Appeals overturned a rule under the Advisers Act permitting fee-based brokerage accounts for certain broker-dealers. Under federal securities laws, broker-dealers may not receive compensation based on a percentage of assets in a client's account unless they are registered under the Advisers Act.

According to the lawsuits, pursuant to the 1940 Act and Rule 38a-1 (the compliance program rule thereunder), the board of a mutual fund has ultimate responsibility for ensuring compliance with all federal securities laws. Each complaint alleges that by authorizing payments not permitted under the Advisers Act, the funds and their boards have abdicated their duties under Rule 38a-1. The lawsuits generally assert a claim under Section 47(b) of the 1940 Act against each fund's distributor that seeks to void the existing distribution agreement, a breach of contract action against each distributor and claims for breach of fiduciary duty and waste against the funds' directors.

In *Smith v. Franklin Templeton*, the U.S. District Court for the Northern District of California dismissed claims made against Franklin Templeton, but permitted the plaintiff to amend his complaint with respect to the sole federal claim. The judge in the case disagreed with the theory that Section 47(b) of the 1940 Act provides a separate cause of action or basis of liability for a claim, as well as the plaintiff's reading of the D.C. Circuit Court of Appeals case regarding fee-based brokerage accounts. The opinion noted that, in the absence of some other violation of the 1940 Act, Section 47(b) alone is insufficient to support a private right of action. In characterizing the *Financial Planning Association* decision as "irrelevant" to the claims before the court, the judge distinguished the service-based fees that violate the prohibition on asset-based compensation from distribution fees paid by Franklin Templeton under Rule 12b-1.

On October 22, 2010, the U.S. District Court for the Northern District of California dismissed the plaintiff's amended complaint in *Franklin Templeton*. In addition to again finding that the plaintiff had failed to allege sufficient facts to state a claim, Judge Hamilton ruled that Sections 36(a) and 47(b) under the 1940 Act do not offer a basis of liability under which plaintiffs may sue. The holding also confirmed the court's previous ruling that Rule 38a-1 under the 1940 Act does not provide either an express or implied private right of action, and that the Rule does not impose on funds a duty to assure that broker-dealers comply with registration requirements. Rather, Rule 38a-1 only requires funds to adopt and implement compliance programs that are reasonably designed to prevent violation of the federal securities.

The ruling by the Northern District of California court could have a significant impact on two other cases with similar allegations involving Eaton Vance and Oppenheimer Funds. A Massachusetts court in *Eaton Vance* recently held a hearing regarding the defendants' motion to dismiss, while the case against Oppenheimer Funds was transferred from Colorado to New York in October 2010.

Massachusetts Supreme Court Rules on Application of the Business Judgment Rule

On August 23, 2010, the Supreme Judicial Court of Massachusetts issued its ruling in *Helabian v. Berv*, that the business judgment rule can be applied to dismiss a derivative complaint filed timely under the Massachusetts Business Corporations Act but prior to a corporation's rejection of the demand serving as the basis for the suit. Previously, the District Court for the Southern District of New York dismissed a shareholder's derivative action for an alleged breach of fiduciary duty by the Board of CitiFund Trust in connection with the approval of new investment advisory agreements following Legg Mason Inc.'s acquisition of Citigroup's asset management business. In dismissing the suit, the district court relied upon the trustees' good-faith determination (i.e., their business judgment) that prosecuting the action would not be in the fund's best interests.

The Massachusetts Act contains a universal demand requirement that prevents shareholders from filing a derivative action until a board has had at least 90 days to evaluate the claim and make a formal recommendation. The district court found that, although the plaintiff had satisfied the demand requirement before filing suit, the Board's decision not to pursue the action required dismissal of the lawsuit, despite the fact that it came six weeks after the 90-day period for review had expired. The district court's analysis was based largely on its interpretation of a provision the Act, which states that a derivative proceeding commenced after the rejection of a demand shall be dismissed by the court on motion by the corporation.

On appeal, the Second Circuit reversed the district court's decision, but withheld judgment in the case, opting to certify a question to the Supreme Judicial Court of Massachusetts. The Second Circuit will now make a final judgment on the appeal.

Ninth Circuit Finds No Private Right of Action under Section 13 of the 1940 Act

On August 12, 2010, the Ninth Circuit reversed the district court's ruling in the case involving the Schwab YieldPlus Fund in holding that nothing in Section 13 of the 1940 Act creates a private cause of action or recognizes that one exists with the clarity and specificity required under Supreme Court precedent. In the Schwab case, the fund had a fundamental policy not to concentrate (i.e., invest more than 25% of its assets) in any industry. In 2001, the fund began classifying non-agency mortgage-backed securities ("MBS") as a separate industry for concentration purposes and disclosed this in its SAI as a non-fundamental policy. Subsequently, in 2006, the fund identified non-agency MBS as not being part of any industry for purposes of its concentration policy and disclosed this fact in its SAI. The plaintiffs alleged that, by the end of February 2008, the fund had slightly more than 50% of its assets in MBS. The district court judge ruled that the fund violated Section 13 of the 1940 Act in not submitting these changes in industry classification to shareholders for approval. In its opinion, the Ninth Circuit stated that the language of Section 13, the structure of the 1940 Act and legislative history do not reflect any congressional intent to create, or recognize a private right of action, to enforce Section 13. The Ninth Circuit disagreed that the Sudan Accountability and Divestment Act's bar to particular litigation is sufficient to constitute recognition of a pre-existing private right of action that is not otherwise evident in the language or structure of the 1940 Act.

OTHER NEWS

President's Working Group Releases Report on Money Market Funds

In October 2010, the President's Working Group on Financial Markets released its report, Money Market Fund Reform Options, which sets forth options for additional money market reform to be considered by the Financial Stability Oversight Council. The Council is charged with identifying and pursuing those options that are most likely to reduce money market funds' susceptibility to runs, with the primary goal of mitigating systemic risk and containing the effect an individual money market fund can have on other money market funds or the broad financial system. The SEC is charged with soliciting public comments, including supporting documentation, on the options.

The report describes five features of money market funds, their sponsors and their investors that make the funds susceptible to runs, including: (1) maturity transformation with limited liquidity resources; (2) net asset values (NAVs) rounding to \$1.00; (3) portfolios exposed to credit and interest rate risks; (4) discretionary sponsor capital support; and (5) investors' low risk tolerance and risk-free expectations. The report acknowledges that the SEC's recent money market reforms addressed some of these features, but discusses the need for additional reform to address systemic risk and the funds' structural vulnerabilities.

The report sets forth the benefits and drawbacks of seven options aimed at reducing money market funds' susceptibility to runs. The options include measures both within and beyond the SEC's current regulatory authority. These options include: (a) requiring floating NAVs; (b) establishing private emergency liquidity facilities for money market funds (the facility described in the report would not assist funds that take on excessive capital risks or have isolated credit losses); (c) requiring mandatory redemptions-in-kind for large redemptions by institutional investors; (d) implementing an insurance program for money market funds; (e) creating a two-tier system of money market funds, with enhanced protection and more stringent requirements for stable NAV funds; (f) creating a two-tier system of money market funds with stable NAV funds reserved for retail investors; and (g) regulating stable NAV money market funds as special purpose banks.

The report acknowledges that further regulation of money market funds may motivate investors to invest their money with unregulated counterparties that may pose even greater systemic risk than money market funds. The report also notes the significance of money market funds in the U.S. financial system and suggests that any changes be considered carefully.

CFTC and SEC Staff Issue Joint Report on May 6, 2010 Market Events

In a September 30, 2010 report to the Joint Advisory Committee on Emerging Regulatory Issues, the staffs of the CFTC and the SEC detailed their findings regarding the market events of May 6, 2010. The report reflects the culmination of market data analysis and interviews with various market participants and exchanges regarding the events of May 6, and describes the events in terms of two liquidity crises.

The report states that on May 6, the markets opened turbulently on news of the European debt crisis. When the Euro began a sharp decline against the U.S. Dollar and Japanese Yen, volatility pauses on the New York Stock Exchange and the S&P 500 volatility index both increased, yields of ten-year Treasuries decreased, the Dow Jones Industrial Average fell, and there was a drop in both buy-side liquidity in E-Mini S&P 500 futures contracts and the SPDR S&P 500 ETF Trust (SPY).

The report describes the first liquidity crisis at the broad index level in the E-Mini. According to the report, against the backdrop of turbulent market conditions, a large fundamental trader entered an order to sell 75,000 E-Mini contracts via an automated execution algorithm at an execution rate calculated based on trading volume without regard to price or time. During this time, high frequency traders traded E-Mini contracts comprising nearly 33% of the total trading volume, which triggered the algorithm, feeding additional contracts into the market even though fundamental buyers in the futures market and cross-market arbitrageurs had not absorbed the previous orders.

According to the report, a series of factors, including sell pressure from the algorithm, lack of demand from fundamental buyers and cross-market arbitrageurs and a "hot potato" volume effect as high frequency traders rapidly traded the same positions back and forth, contributed to rapid declines in the prices of the E-Mini and SPY. The sudden decline in price and liquidity triggered a five-second regulatory trading pause. From the start of the algorithm until the trading pause, the algorithm sold 35,000 contracts. During the same time, all fundamental sellers combined sold more than 80,000 contracts, resulting in a net imbalance of 30,000 contracts. As the prices stabilized, the algorithm continued to sell the remaining 40,000 contracts.

The report describes the second liquidity crisis with respect to individual stocks. According to the report, in reaction to the E-Mini crisis, the automated trading systems used by many liquidity providers also paused as designed to allow traders and risk managers to perform a risk assessment of continued trading. As a result, some market makers and liquidity providers widened quote spreads, reduced liquidity and a significant number withdrew from the markets. The reduced liquidity caused further price declines until eventually, liquidity evaporated in a number of individual securities and ETFs. Those participants instructed to trade at market found no interest, resulting in trades during this time being executed at prices ranging from 1¢ to $100,000. After market close, the exchanges and FINRA later agreed to cancel trades that were executed at a price more than 60% away from their value prior to the market events under their “clearly erroneous” trade rules.

In response to the May 6 events and to provide clarity around when erroneous trades will be broken, regulators established the circuit breaker program and related procedures. The report states that the CFTC and SEC staffs will work with market centers to review their members’ trading practices to identify any abusive or manipulative conduct that may cause system delays that inhibit a fair and orderly process of price discovery.

SEC’s Enforcement Head Testifies on Mutual Fund Fee Initiative

On September 22, 2010, Robert Khuzami, the head of the SEC’s Division of Enforcement, discussed a “Mutual Fund Fee Initiative” during his testimony before the Senate Committee on the Judiciary. When discussing the SEC's newly-created asset management unit (which focuses on mutual funds, private funds and investment advisers), Mr. Khuzami noted that the unit, along with the other SEC divisions, has established a Mutual Fund Fee Initiative to develop analytics for inquiries into the extent to which mutual fund advisers charge retail investors excessive fees. He stated that the analytics are expected to result in examinations and investigations of investment advisers and fund boards concerning duties under the 1940 Act.

SEC Issues No-Action Letter on Soft Dollar Arrangements

On September 21, 2010, the SEC issued a no-action letter to BNY ConvergEx Group, LLC stating that a broker-dealer’s provision of research services to an institutional investment adviser would not establish an adviser-client relationship under the Advisers Act between the broker-dealer and the institutional investment adviser’s clients. According to BNY ConvergEx’s letter, many research broker-dealers have refused cash payments for their proprietary research from executing brokers because the investment adviser’s clients may be viewed as the research broker-dealer’s clients and, as a result, the principal transaction restrictions under the Advisers Act may apply.

SEC Staff Issues No-Action Letter and Interpretation under Rule 2a-7

On August 19, 2010, the SEC staff issued a no-action letter to the ICI providing that the Division of Investment Management would not recommend enforcement action against any money market fund that does not comply with the requirements concerning the designation of nationally recognized statistical rating organizations (“NRSROs”) in amended Rule 2a-7 under the 1940 Act before the SEC has completed its review of Rule 2a-7 as required by the Dodd-Frank Act and made any modifications to the Rule. Rule 2a-7 amendments adopted earlier this year would require that, by December 31, 2010, a fund's board designate at least four NRSROs whose ratings would be use to determine portfolio security eligibility under the Rule and the fund disclose such NRSROs in its SAI. The Dodd-Frank Act requires the SEC to review and modify regulations referring to or requiring reliance on credit ratings and to substitute a standard of creditworthiness as determined appropriate by the SEC, which industry participants pointed out would render the NRSRO designations irrelevant. The letter provides that money market funds relying on the no-action letter must continue to comply with the obligations for determining and monitoring eligible securities set forth in Rule 2a-7 as in effect before May 5, 2010 (with the exception of the limitation on holding unrated asset-backed securities rescinded by the 2010 amendments to Rule 2a-7).

In addition, earlier in August 2010, in response to an ICI request for interpretation, the SEC staff agreed that, for purposes of calculating a money market fund's weighted average portfolio maturity under Rule 2a-7, a fund may treat short-term floating rate securities subject to a demand feature as having a maturity equal to the period remaining until the principal can be recovered through demand, which thereby treats these securities the same as short-term variable rate securities subject to a demand feature.

ENFORCEMENT ACTIONS

SEC Charges Hedge Fund Manager with Defrauding Investors by Overvaluing Fund Position

On October 25, 2010, the SEC charged Southridge Capital Management LLC and Southridge Advisors LLC, each unregistered hedge fund advisers, and their principal, Stephen Hicks, for defrauding investors. First, the SEC alleged that Mr. Hicks overvalued the largest position held by certain funds by fraudulently misstating the acquisition price of the assets, thereby causing the funds to pay or accrue more than $1.8 million of management fees since 2004. According to the SEC's complaint, in early 2004, Mr. Hicks arranged the sale of a company acquired by the funds as a result of a defaulted note to Fonix Corporation in exchange for securities with a stated value of $33 million. The complaint alleged that neither the company sold nor the Fonix securities obtained in the transaction were accurately valued and that Fonix securities were thereafter wrongfully valued at acquisition cost.

Second, the SEC alleged that beginning in late 2003, Mr. Hicks fraudulently solicited investors to put money in new funds that were supposed to have a majority of their investments in unrestricted, free-trading liquid shares, cash or near cash. According to the SEC's complaint, Mr. Hicks raised $80 million for the new funds and at year-end 2006 more than half of the assets in one new fund (and more than one-third of the assets in another new fund) were invested in relatively illiquid assets. The SEC alleged that by 2007 investors had submitted nearly $7 million in redemption requests that were unable to be satisfied.

Finally, the SEC alleged that between 2005 and 2008, the Southridge advisers and Mr. Hicks caused certain of the funds that had available cash to pay approximately $5 million of legal and administrative expenses of older funds that were illiquid and had no available cash. The SEC's complaint alleged that investors in the funds from which money was taken were not told about this misappropriation of fund assets while it was taking place. Instead, in February 2009, Mr. Hicks sent a letter to investors admitting that certain legal and administrative expenses had been improperly allocated between the funds, but rather than repaying the money to the funds, the Southridge advisers and Mr. Hicks transferred certain illiquid securities.

Former State Street Employees Charged by SEC for Misleading Investors About Subprime Mortgage Investments

On September 30, 2010, the SEC charged two former employees at State Street Bank and Trust Company with misleading investors about their exposure to subprime investments in State Street's Limited Duration Bond Fund. The SEC charged State Street in a related case earlier this year, in which the firm agreed to settle the charges by repaying fund investors more than $300 million. When the SEC announced its settlement with State Street in February, it also announced that State Street had agreed—pursuant to a limited privilege waiver—to provide information to enable the SEC to assess the potential liability of individuals involved with State Street's investor communications about the fund.

According to the order, John P. Flannery, formerly the chief investment officer, and James D. Hopkins, formerly a product engineer, played an instrumental role in drafting a series of misleading communications beginning in July 2007. The communications to investors related to the effect of the turmoil in the subprime market on the Limited Duration Bond Fund and other State Street funds that invested in it. According to the SEC, State Street provided certain investors, including State Street's internal advisory groups, with more complete information about the fund's subprime concentration and other problems with the fund.

SEC Charges Broker-Dealer for Deficient CIP Procedures

On September 1, 2010, the SEC charged Pinnacle Capital Markets LLC, a broker-dealer, with failing to comply with customer identification program ("CIP") requirements. Pinnacle's managing director, Michael A. Paciorek, was also charged with causing Pinnacle's violations. According to the order, Pinnacle established, documented and maintained a CIP that specified it would identify and verify the identities of all of its customers; however, during a six-year period, Pinnacle failed to follow the identification and verification procedures set forth in its CIP.

According to the order, many of Pinnacle's foreign institutional customers hold omnibus accounts at Pinnacle through which the entities carry sub-accounts for their own corporate or retail customers and the sub-account holders are treated in the same manner as regular account holders. Also, according to the order, Pinnacle did not verify the identities of 34 out of a sample of 55 corporate account holders from October 2003 to August 2006, and from October 2003 through November 2009, Pinnacle did not collect or verify identifying information for the vast majority of the beneficial owners of sub-accounts maintained by Pinnacle's omnibus brokerage accounts. As a result, the SEC found that Pinnacle's documented procedures differed materially from its actual procedures. Pinnacle and Mr. Paciorek agreed to settle the SEC's enforcement action without admitting or denying the allegations, and Pinnacle will pay $25,000 in penalties.

SEC Charges Former Audit Partner and Son With Insider Trading

On August 4, 2010, the SEC charged Thomas P. Flanagan, a former Deloitte & Touche LLP vice chairman and partner in the firm's Chicago office, and his son, Patrick T. Flanagan, with insider trading in the securities of several of the firm's audit clients. The SEC alleged that Thomas Flanagan had access to advance earnings results, earnings guidance, acquisition information and other nonpublic information from Deloitte's audit engagements with Best Buy, Sears and Walgreens, as well as the firm's consulting engagement with Motorola, and traded in the securities of such clients. According to the SEC, Thomas Flanagan committed insider trading nine times between 2005 and 2008 and tipped his son who then traded on the basis of the nonpublic information.

In addition to the complaint alleging insider trading, the SEC instituted administrative proceedings against Thomas Flanagan, finding that he violated the SEC's auditor independence rules on 71 occasions between 2003 and 2008 by trading in the securities of Deloitte audit clients. The SEC's settled administrative order finds that Thomas Flanagan caused and willfully aided and abetted Deloitte's violations of the SEC's auditor independence rules and Deloitte's clients' violations of the reporting and proxy provisions of the Exchange Act.

Thomas Flanagan consented to the entry of an order of permanent injunction, disgorgement with prejudgment interest of $557,158 and a penalty of $493,884, and Patrick Flanagan consented to the entry of an order of permanent injunction, disgorgement with prejudgment interest of $65,614 and a penalty of $57,656.

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