Investment Services Regulatory Update

July 1, 2011

LITIGATION

Supreme Court Rules on Who Is the "Maker" of Statements Under Section 10(b)

On June 13, 2011, the U.S. Supreme Court issued its ruling in *Janus Capital Group, Inc. v. First Derivative Traders*. In a 5-4 decision, the Supreme Court held that a mutual fund investment adviser cannot be held liable by the shareholders of the investment adviser's publicly-traded parent company for fraud under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, where the investment adviser did not "make" the false statements in its mutual funds' prospectuses.

The sole question before the Supreme Court was whether Janus Capital Management LLC ("JCM"), as investment adviser, could be held liable in a private action filed by the shareholders of the investment adviser's parent company under Rule 10b-5 for false statements included in its client Janus Investment Fund's ("Funds") prospectuses. In their complaint, shareholders of parent company Janus Capital Group ("JCG") sued both JCG and its subsidiary JCM for fraud under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, as well as control person liability under Section 20(a) of the Exchange Act.[1] According to the complaint, the Funds managed by JCM issued prospectuses creating the "misleading impression" that JCG and JCM would implement measures to "curb market timing" in the Funds. Following revelations that the Attorney General of the State of New York had filed a complaint against JCG and JCM alleging that JCG had actually permitted market timing in several of the Funds managed by JCM, investors withdrew money from the Funds and JCG's stock price fell nearly 25%. The plaintiffs alleged that JCG and JCM made false statements in prospectuses filed by the Funds and that those statements affected the price of JCG's stock. The complaint, however, did not allege that defendants JCG or JCM actually issued the prospectuses containing the disclosures regarding the market timing policies.

The district court dismissed the complaint for failure to state a claim against JCG and JCM. The court concluded that JCM's dissemination of the prospectuses did not rise to the level of making a misstatement and that the plaintiffs failed to demonstrate that the alleged fraud occurred in connection with the purchase or sale of a security, since there was no nexus between plaintiffs as JCG shareholders and JCM. On appeal, the Fourth Circuit reversed—holding that the plaintiffs sufficiently alleged that "JCM, by participating in the writing and dissemination of the prospectuses, made the misleading statements

[1] Although the plaintiffs originally alleged that JCG violated Rule 10b-5, on writ of certiorari to the Supreme Court, they sought to hold JCG liable only as a control person of JCM under Section 20(a). Because Section 20(a) applies only to those who control other parties who may be held liable for securities law violations, whether the plaintiffs stated a claim against JCG depended on whether the plaintiffs had stated a claim against JCM. Thus, if JCM could not be held liable under Section 10(b), JCG could not be liable as a control person under Section 20(a).

contained in the documents" and that JCG could be held liable as a control person of JCM.

The Supreme Court ruled that plaintiffs failed to state a Rule 10b-5 claim against JCM, because only the Funds were ultimately responsible for making the alleged misstatements. Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, for a person to directly or indirectly "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading." The Court focused on the meaning of the word "make" and determined that JCM, as investment adviser, did not "make" the allegedly material misstatements in the Funds' prospectuses. Specifically, the Court held "[f]or Rule 10b-5 purposes, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." The Court went on to note that "[o]ne who prepares or publishes a statement on behalf of another is not its maker." The Court likened the relationship between an investment adviser and its mutual fund client to the relationship between a speechwriter and a speaker and rejected the analogy that an adviser is a "playwright whose lines are delivered by an actor." Thus, even if an investment adviser assists with the drafting or distribution of a prospectus, the investment adviser is a mere speechwriter and the mutual fund, as the speaker, has the ultimate responsibility for statements in a prospectus. Further, the Court noted that the Funds had ultimate responsibility for statements in their prospectuses because the Funds, unlike the investment adviser, are required to file the prospectuses with the SEC.

The Court acknowledged the plaintiffs' arguments that there is a "uniquely close relationship between a mutual fund and its investment adviser," but noted that the Funds were a legally independent entity with their own board of trustees, separate and apart from JCG and JCM. Further, the Court opined that "[a]ny reapportionment of liability in the securities industry in light of the close relationship between investment advisers and mutual funds is properly the responsibility of Congress and not the courts." Thus, the Court held that plaintiffs had not stated a claim against JCM under Rule 10b-5.

The dissent took issue with the majority's bright line test for primary liability and its finding that a maker of a statement is the person who had "ultimate authority" over the statement. In the dissent's view, neither common English nor the Court's earlier cases limit the scope of the word "maker" to those with "ultimate authority" over a statement's content. The dissent contended that the relationships (e.g., JCM's involvement in preparing and writing the relevant statements) alleged among JCM and the Funds and the statements in the Funds' prospectuses warranted a conclusion that JCM "made" those statements.

NEW RULES, PROPOSED RULES AND GUIDANCE

SEC Adopts Rules Relating to Investment Adviser Registration

On June 22, 2011, the SEC adopted several new rules and rule amendments under the Advisers Act in order to implement certain provisions of the Dodd-Frank Act.

Mid-Sized Adviser Transition. Rule 203A-5 was adopted in order to provide an orderly transition to state registration for mid-sized advisers. Under the Dodd-Frank Act, advisers with assets under management between $25 million and $100 million are not eligible for registration with the SEC unless the mid-sized adviser's state does not require registration or does not examine advisers, in which case such advisers are required to register with the SEC. Rule 203A-5 provides until March 30, 2012 for any adviser registered with the SEC to determine whether it remains eligible for registration and provides an additional 90 days (until June 28, 2012) to register with the state and withdraw its registration with the SEC. In addition, all advisers registered with the SEC on January 1, 2012 must file an amendment to their Form ADV by March 30, 2012, confirming their eligibility.

Exempt Reporting Advisers. The Dodd-Frank Act eliminates the private adviser exemption, except for foreign private advisers, in Section 203(b)(3) effective July 21, 2011, and creates two new exemptions from registration for certain advisers. Section 203(l) exempts advisers that advise only venture capital funds and Section 203(m) exempts advisers that advise only private funds and have assets under management of less than $150 million. Although they are not required to register with the SEC, Rule 204-4 requires these "exempt reporting advisers" to file reports with the SEC by completing certain sections of Form ADV. Form ADV was amended to accommodate use by exempt reporting advisers, and the information submitted by such advisers will be made public. The SEC also amended Rule 204-1 to require an exempt reporting adviser to amend its reports on Form ADV at least annually. The initial filing on Form ADV by exempt reporting advisers must be made by March 30, 2012.

Venture Capital Funds Defined. Rule 203(l)-1 was adopted to define "venture capital fund" for purposes of the exemption from registration under the Advisers Act for advisers that exclusively advise venture capital funds. A "venture capital fund" is a fund that (1) holds no more than 20% of its capital commitments in non-qualifying investments; (2) does not borrow or incur leverage (other than short-term borrowing); (3) does not offer redemption rights except in extraordinary circumstances; (4) represents itself as pursuing a venture capital strategy to investors; and (5) is not registered under the 1940 Act and is not a business development company. The Rule provides a grandfather provision for funds that began raising capital before the end of 2010 and represented themselves as pursuing a venture capital strategy.

Private Fund Adviser Exemption. Rule 203(m)-1 provides an exemption from registration for any investment adviser that advises only private funds and has less than $150 million in assets under management. The number of funds advised is not a factor. Under the Rule, the adviser must aggregate the value of all of the assets of the private funds it advises in determining its eligibility for this exemption. The adviser must calculate its assets under management annually using market value (or fair value if necessary). A non-U.S. adviser may rely on this exemption as long as all of the adviser's clients are qualifying private funds. The type of its non-U.S. clients and the amount of its non-U.S. assets under management are not considered.

Foreign Private Advisers. Rule 202(a)(30)-1 was adopted to define certain terms used in Section 202(a)(30), which defines "foreign private adviser" for purposes of the Section 203(b)(3) exemption from registration.

Form ADV Amendments. A number of amendments to Form ADV were adopted in order to require advisers to provide additional information about three areas of their business: (1) the private funds advised by an adviser; (2) the types of clients, advisory practices and business practices that may present conflicts of interest (e.g., using affiliated brokers, soft dollar arrangements, compensation for client referrals); and (3) non-advisory activities and financial industry affiliations. Form ADV filings made after January 1, 2012 will need to include the additional required information.

"Pay to Play" Rule. Rule 206(4)-5 was amended to expand its scope to apply to exempt reporting advisers and foreign private advisers. In addition, an adviser is permitted to pay a registered "municipal advisor" to solicit government entities, if the registered municipal advisor is subject to a pay-to-play rule adopted by the MSRB that is at least as stringent as the pay-to-play rule applicable to the adviser. Also, registered broker-dealers and investment advisers that are subject to FINRA's pay-to-play rule may solicit business on behalf of an adviser from a state or local government entity. The Rule amendments become effective 60 days after publication in the Federal Register.

SEC Adopts Rule Defining "Family Office" Adviser

On June 22, 2011, the SEC adopted Rule 202(a)(11)(G)-1 under the Advisers Act defining the term "family office" for the purpose of excluding family office advisers from the definition of "investment adviser" in the Advisers Act, and thereby exempting them from registration as investment advisers under the Advisers Act. The Rule generally defines "family office" as a company that (1) has no clients other than family members; (2) is wholly owned by family clients and is controlled by family members; and (3) does not hold itself out to the public as an investment adviser. The Rule becomes effective 60 days after publication in the Federal Register.

CFTC and SEC Issue Guidance to Address Dodd-Frank Act Swap Provisions

In light of the impending July 16, 2011 effective date for certain derivatives provisions of the Dodd-Frank Act and the number of swap rulemakings that have not been finalized, both the CFTC and the SEC issued guidance regarding the effective date of various statutory and regulatory requirements for swaps. The CFTC issued a proposed exemptive order, requesting public comments by July 1, 2011. Although the SEC issued a final exemptive order effective June 15, 2011, public comments were requested on the guidance and the temporary relief granted. Under the Dodd-Frank Act, the derivatives provisions that do not have a designated effective date will become effective on the later of (1) where rulemaking was required, not less than 60 days after publication of a final rule, or (2) where rulemaking was not required, July 16, 2011 (the "self-effectuating provisions").

CFTC Guidance. The CFTC proposed order categorizes the derivatives provisions of the Dodd-Frank Act as (1) provisions requiring a rulemaking; (2) self-effectuating provisions that reference terms requiring further definition; (3) self-effectuating provisions that do not reference terms requiring further definition and that repeal provisions of current law; and (4) self-effectuating provisions for which relief is not being proposed. The CFTC notes that the proposed order reserves the CFTC's anti-fraud and anti-manipulation enforcement authority. The proposed order states that the provisions in categories 1 and 4, which are listed on the CFTC's website, are outside of the scope of the proposed relief and will take effect on July 16, 2011.

With respect to category 2, the CFTC proposes to exempt persons or entities from complying with requirements of the Commodity Exchange Act ("CEA") that go into effect July 16 and that refer to one or more terms requiring further definition, including "swap," "swap dealer," "major swap participant" or "eligible contract participant." The proposed relief would apply only to those requirements or portions of such provisions that specifically relate to the referenced terms. The proposed relief would extend to the earlier of the effective date of rules defining such terms or December 31, 2011. The proposed order notes that the CFTC's authority to issue exemptive relief may not extend to certain category 2 provisions, and that the CFTC staff is considering whether to issue a no-action letter regarding these provisions.

With respect to category 3, the CFTC proposes to expand the current derivatives exemption under Part 35 of the CEA to replace the CEA exemptions for swaps and other transactions that are being repealed effective July 16. The proposed temporary relief would exempt certain transactions in exempt or excluded commodities from the CEA if the transaction would otherwise comply with Part 35, notwithstanding that: (1) the transaction may be executed on a multilateral transaction execution facility; (2) the transaction may be cleared; (3) persons offering or entering into the transaction may be eligible contract participants as defined in the CEA prior to July 16; (4) the transaction may be part of a fungible class of agreements that are standardized as to their material economic terms; and/or (5) no more than one of the parties to the transaction is entering into the transaction in conjunction with its line of business, but is neither an eligible contract participant nor an eligible swap participant as defined in the CEA, and the transaction was not and is not marketed to the public. The proposed relief would extend to the earlier of the repeal or replacement of Part 35 or Part 32 of the CEA or December 31, 2011.

SEC Guidance. The SEC order provides guidance and temporary relief with respect to the July 16 effective date for certain Dodd-Frank Act provisions relating to security-based swaps. The SEC order identifies those provisions requiring rulemaking for effectiveness, including those that are dependent on such rulemaking, and states that such provisions will go into effect not less than 60 days after publication of a final rule. The SEC order also notes that a number of the Dodd-Frank Act provisions relating to security-based swaps apply only to "registered" persons and that until the registration processes have been established by final SEC rules and such persons have become registered pursuant to the rules, they will not be required to comply with the provisions. The SEC order also identifies those provisions that are self-effectuating and states

whether temporary relief has been granted with respect to the provisions, or, if temporary relief was not granted in the order, whether the SEC will consider requests for relief from compliance with the provision. The SEC order states that the temporary relief will expire upon the adoption of related final rules and the compliance dates specified in the related final rules.

The SEC order also states that on July 16, security-based swaps will become "securities" subject to the general anti-fraud and anti-manipulation provisions of the federal securities laws. In response to market participant comments, the SEC order notes that the SEC intends to separately address requests for relief from certain provisions of the federal securities laws that will impose new obligations on counterparties to security-based swaps in connection with the expansion of the definition of security.

Additionally, the SEC order provides temporary relief from Section 29(b) of the Exchange Act, which may act to void a contract made in violation of any provision of the Exchange Act, or the rules thereunder. The SEC order temporarily exempts any security-based swap contract entered into on or after July 16 from being void or considered voidable by reason of Section 29 of the Exchange Act because any person that is a party to the security-based swap contract violated a provision of the Exchange Act that was amended or added by the Dodd-Frank Act and that has been determined to not be effective as of July 16.

SEC Adopts Whistleblower Rules under the Dodd-Frank Act

On May 25, 2011, the SEC adopted final rules to implement the whistleblower provisions of the Dodd-Frank Act. Regulation 21F under the Exchange Act expands the SEC's ability to reward whistleblowers who alert the SEC to federal securities law violations. Pursuant to the requirements of Regulation 21F, the SEC will pay awards of between 10% and 30% of the monetary sanctions that the SEC and other authorities are able to collect to whistleblowers who voluntarily provide the SEC with original information about a possible violation of federal securities laws that leads to a successful enforcement action with monetary sanctions exceeding $1 million. The SEC will aggregate smaller actions arising from the same set of facts when determining whether reported violations meet the $1 million threshold.

Under Regulation 21F, only a natural person, either alone or jointly with others, is eligible to be a whistleblower. Regulation 21F generally allows for whistleblower anonymity and otherwise provides that the SEC will not reveal a whistleblower's identity, except under certain circumstances. Anonymous whistleblowers must be represented by an attorney who is required to provide certification as to the whistleblower's identity and the completeness and accuracy of the whistleblower's submission. In order to receive an award as a whistleblower, the following requirements apply:

- the whistleblower must voluntarily provide the SEC with the information,

- the whistleblower must provide original information based on his/her independent knowledge or analysis, and
- the whistleblower's information must lead to successful enforcement by the SEC of a federal court or administrative action, which could be satisfied: (1) if the information was sufficiently specific, credible and timely to cause the staff to (a) commence an examination, (b) open an investigation, (c) reopen an investigation that the SEC had closed, or (d) inquire concerning different conduct as part of a current examination or investigation and the SEC's successful enforcement was based on the information, (2) if the conduct was already under investigation when the information was submitted, but the information significantly contributed to the success of the action, or (3) if the whistleblower reported information through the company's internal reporting system and the company reported the information to the SEC, leading to successful enforcement.

Regulation 21F does not require whistleblowers to report possible securities law violations through a company's internal reporting system before submission to the SEC in order to be eligible for an award; however, the SEC adopted certain provisions in an effort to incentivize whistleblowers' utilization of internal compliance and reporting systems. In determining the amount of the award, a whistleblower's participation in a company's internal compliance and reporting system is a factor that can increase the amount of the award, while interference with the internal compliance and reporting system can decrease the amount. In addition, when a possible violation is reported to the SEC by a company based on information provided by a whistleblower through the company's internal compliance and reporting system, all the information provided by the company to the SEC in any resulting investigation will be attributed to the whistleblower, potentially increasing the amount of the whistleblower's award.

Regulation 21F provides that culpable whistleblowers may not recover awards and are not given amnesty. Additionally, individuals whose job descriptions require them to investigate and uncover corporate wrongdoing generally may not receive an award.

Regulation 21F becomes effective on August 12, 2011.

SEC Proposes Adjustment to Dollar Amount Thresholds and Rule Amendment Relating to Investment Adviser Performance Fees

On May 10, 2011, the SEC gave notice of its intent to issue an order that would adjust for inflation the dollar amount tests for determining if a person is a "qualified client" for purposes of Rule 205-3 under the Advisers Act, which permits investment advisers to charge a performance fee to "qualified clients." Currently, a person would be considered a "qualified client" for purposes of Rule 205-3 if the person had at least $750,000 under the management of the adviser immediately after entering into the advisory contract or the adviser reasonably believed that the person had a net worth of more than $1.5 million at the time the advisory contract was entered into. The SEC's order will increase these thresholds to $1 million and $2 million, respectively. In addition to stating its intent

to adjust the dollar amount tests for determining if a person is a "qualified client," the SEC also proposed further amendments to Rule 205-3 to: (1) provide that the SEC will adjust the dollar amount thresholds for inflation approximately every five years; (2) exclude the value of a person's primary residence for purposes of determining a person's net worth under the Rule; and (3) clarify that the amended Rule requirements would apply to new contractual arrangements and not to existing contractual arrangements, except that new parties to existing contracts would be subject to the amended Rule requirements.

Comments on the proposals are due by July 11, 2011. The SEC intends to issue the order adjusting the dollar amount tests of Rule 205-3 by July 21, 2011 in accordance with the requirements of the Dodd-Frank Act.

FINRA Proposes New Rules Governing Fund Cash Compensation Disclosure

On May 3, 2011, the SEC published for comment a proposal by FINRA to adopt NASD Rule 2830 as FINRA Rule 2341 in the consolidated FINRA rulebook and to make amendments to FINRA Rule 2341. As amended, Rule 2341 would require FINRA members to make new disclosures to investors purchasing fund shares relating to the member's arrangements to receive "cash compensation" from the fund or its affiliates. Rule 2341 defines "cash compensation" to include any "discount, concession, fee, service fee, commission, asset-based sales charge, loan, override or cash employee benefit received in connection with the distribution of investment company securities." FINRA's proposed amendments to Rule 2341 clarify that "cash compensation" includes revenue sharing payments regardless of whether payments are based upon the amount of fund assets that a member's customers hold, the amount of fund shares the member has sold, or any other amount if the payment is related to the sale and distribution of the fund's shares. The current rule requires "cash compensation" arrangements to be disclosed in a fund's prospectus and SAI. Amended Rule 2341 would no longer require prospectus and SAI disclosure.

Under the proposed amendments to Rule 2341, if a FINRA member has received, or entered into an arrangement to receive, cash compensation from an offeror (i.e., a fund, its adviser, a fund administrator, fund underwriter or any of their affiliated persons) other than sales charges and fees disclosed in the prospectus fee table, the member must provide: (1) prominent disclosure that the member has received, or has entered into an arrangement to receive, cash compensation, in addition to the sales charges/service fees disclosed in the prospectus (including fees for services such as sub-transfer agency and sub-administration fees); (2) prominent disclosure that the additional cash compensation may influence the selection of funds that the customer may be offered or recommended; and (3) a prominent reference to a web page or toll-free number where the investor can obtain detailed additional information regarding these arrangements. This additional detailed information regarding cash compensation arrangements must include: (a) a narrative description of the additional cash compensation received from offerors, or to be received pursuant to an arrangement entered into with an offeror, and any services provided, or to be provided, by the member to the offeror or its affiliates for this additional cash compensation; (b) if applicable, a narrative description of any

preferred list of funds to be recommended to customers that the member has adopted as a result of the receipt of additional cash compensation, including the names of the funds on this list; and (c) the names of the offerors that have paid, or entered into an arrangement with the member to pay, this additional cash compensation to the member. Each FINRA member would be required to update this information within 90 days of December 31st of each year, or when any of the information becomes materially inaccurate.

The disclosures required under amended Rule 2341 would have to be provided to new customers prior to the time that the customer first purchases shares of a fund through the FINRA member firm. Existing customers would have to receive the information required under amended Rule 2341 by the later of either: (a) 90 days after the effective date of the rule change or (b) prior to the time that the existing customer purchases shares of a fund after the rule's effective date (other than purchases pursuant to reinvestment of dividends or capital distributions through automatic investment plans).

If approved by the SEC, the proposed amendments to Rule 2341 would become effective on such date designated by the SEC or consented to by FINRA. Following the effective date, FINRA, within 90 days, will publish a *Regulatory Notice* setting the compliance date for amended Rule 2341, which will be no later than one year from the effective date.

OTHER NEWS

Office of Inspector General Releases Report on Compliance with SEC Exemptive Orders and No-Action Letters

On June 29, 2011, the SEC's Office of Inspector General released a report assessing the SEC's processes for ensuring adherence to the conditions under which exemptive orders and no-action letters are granted. The report concluded that the SEC's divisions that issue exemptive relief do not have a coordinated process for reviewing compliance with the conditions and representations contained in the orders and letters, and instead rely on the Office of Compliance Inspections and Examinations (OCIE) to review compliance as part of its examinations. The report emphasizes the importance of monitoring compliance because the exemptions allow companies to conduct activities that, without the relief, could violate securities laws and regulations. Accordingly, the report makes five recommendations intended to enhance the SEC's oversight of compliance with exemptive relief and increase coordination with OCIE in the examination of companies for compliance with conditions and representations contained in exemptive relief. In response to the report, the SEC was asked to submit a corrective action plan within 45 days.

FASB Issues Accounting Standards Update on Fair Value Measurement

In May 2011, the Financial Accounting Standards Board released an Accounting Standards Update to *Fair Value Measurement (Topic 820)* that amends certain fair value measurement and disclosure requirements. The Update is a culmination of the work

performed by FASB and the International Accounting Standards Board to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards. The Update reflects a number of amendments to the requirements for measuring fair value and the application of such fair value measurements. According to the Update, many of those amendments are not expected to significantly affect current practices for reporting entities.

The Update also reflects amendments to certain fair value disclosure requirements. In particular, a reporting entity will be required to disclose the amount of *any* transfers between Level 1 and Level 2 of the fair value hierarchy. (Currently, only the amounts of *significant* transfers between Level 1 and Level 2 are required to be disclosed.) Additionally, with respect to Level 3 fair value measurements, a reporting entity will be required to:

- disclose the quantitative information about the significant unobservable inputs used in the fair value measurement (however, no disclosure will be required if the quantitative unobservable inputs were not developed by the reporting entity (e.g., when the reporting entity uses third-party pricing information without adjustment));

- provide a description of the valuation process used by the reporting entity (including, for example, how the entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period); and

- provide a narrative description of (1) the sensitivity of a fair value measurement to changes in unobservable inputs, if a change in those inputs might result in a significantly different fair value measurement, and (2) any interrelationships between those inputs and other unobservable inputs used in the fair value measurement and how such interrelationships might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

The amendments in the Update are effective during interim and annual periods beginning after December 15, 2011.

ENFORCEMENT ACTIONS

Morgan Keegan Settles Fraud Charges Related to Valuations of Subprime Mortgage-Backed Securities

On June 22, 2011, the SEC, state regulators and FINRA announced that Morgan Keegan agreed to pay $200 million to settle fraud charges related to valuations of subprime mortgage-backed securities held by five Morgan Keegan funds. The settlement also prohibits Morgan Keegan from valuing fair valued securities on behalf of

funds for three years. Finally, two employees of Morgan Keegan, including the funds' portfolio manager, agreed to pay $500,000 and $50,000 in penalties, respectively.

The SEC found that Morgan Keegan and the two employees caused the false valuation in 2007 of subprime mortgage-backed securities in five funds managed by Morgan Keegan. According to the SEC, Morgan Keegan failed to employ reasonable pricing procedures with respect to the valuation of the funds' portfolio securities, which resulted in the calculation and dissemination of inaccurate net asset values. Specifically, the SEC found that the funds' portfolio manager instructed the fund accounting department to make arbitrary "price adjustments" to the fair values of certain portfolio securities that ignored lower values for those same securities provided by outside broker-dealers as part of the pricing process, and often lacked a reasonable basis. The SEC also found that the portfolio manager instructed fund accounting to lower values over a period of days, instead of when pricing information was received. Moreover, the SEC found that the portfolio manager screened and influenced the price confirmations received from at least one broker-dealer.

SEC Charges Investment Adviser with Undisclosed Cash Payments

On June 15, 2011, the SEC charged Pegasus Investment Management, LLC, a registered investment adviser and the general partner of two private funds, and two of its officers in connection with undisclosed cash payments. According to the SEC, between 2008 and 2009, Pegasus aggregated its futures trades with a proprietary trading firm's trades placed through a common broker in order for the proprietary trading firm to obtain reduced commission rates from the broker and, in exchange, the proprietary trading firm made monthly cash payments to Pegasus. The proprietary trading firm paid an estimated $90,000 in cash to Pegasus under this arrangement. Pegasus treated the $90,000 as its own asset and did not disclose the arrangement to the funds' investors in offering documents, partnership agreements or Pegasus' Form ADV. The SEC found that Pegasus' arrangement with the proprietary trading firm constituted fraud, and Pegasus was ordered to pay disgorgement of $90,000 and prejudgment interest of $5,469. Two of Pegasus' officers were censured and ordered to pay civil money penalties in the amounts of $50,000 and $25,000, respectively.

FINRA Fines Wells Fargo for Delayed Prospectus Deliveries

On May 5, 2011, FINRA announced that it fined Wells Fargo Advisors LLC $1 million for its failure to deliver prospectuses to customers purchasing mutual funds in 2009 and for delays in reporting material information, including arbitrations and complaints, about its current and former representatives. Federal securities laws require that a prospectus be delivered to a customer within three days of the purchase of a security. FINRA found that during 2009, Wells Fargo delivered late prospectuses to more than 900,000 customers, with delays ranging between one and 153 days. Moreover, FINRA determined that Wells Fargo failed to take any corrective action despite receiving reports from a third party service provider that prospectuses were not being timely delivered.

FINRA also found that Wells Fargo had failed to promptly report changes to or update information contained in its representatives' applications for registration (Form U-4) and representatives' termination notices (Form U-5). Specifically, FINRA found that from July 1, 2008 to June 30, 2009, 8.1% of the Form U-4 amendments and 7.6% of the Form U-5 amendments filed by Wells Fargo were not timely filed.

SEC Charges Brokerage Executives with Failing to Protect Confidential Customer Information

On April 7, 2011, the SEC charged Frederick O. Kraus, David C. Levine and Mark A. Ellis for failing to protect confidential customer information in violation of Regulation S-P. Messrs. Kraus, Levine and Ellis were the former president, national sales manager and chief compliance officer, respectively, of GunnAllen Financial Inc., a former Tampa, Florida-based registered broker-dealer.

According to the SEC, Mr. Levine, with the approval of Mr. Kraus, took information from more than 16,000 GunnAllen accounts to his new employer as GunnAllen wound down operations in April 2010. The SEC found that Mr. Levine downloaded customer names, addresses, account numbers and account values to a portable thumb drive, and provided the records to his new employer after resigning from GunnAllen. Since account holders found out about the information transfer after the fact and were not provided opt-out procedures, the SEC found that the record transfer violated Regulation S-P. Messrs. Kraus and Levine agreed to pay civil penalties of $20,000 each.

The SEC also found that Mr. Ellis, as CCO, aided and abetted and caused GunnAllen's violations of Regulation S-P as a result of his failure to revise or supplement GunnAllen's policies and procedures for safeguarding customer information even after several serious securities breaches between July 2005 and February 2009. According to the SEC, GunnAllen's policies and procedures to protect customer information were vague and did little more than recite a provision of Regulation S-P known as the "safeguard rule." Mr. Ellis agreed to pay a $15,000 civil penalty.

SEC Charges Adviser with Misrepresentations

On April 7, 2011, the SEC instituted cease-and-desist proceedings against Delta Global Advisors, Inc., a registered investment adviser, and its principal and control person, Charles P. Hanlon, with making materially misleading statements and omissions. According to the SEC, Delta made misrepresentations to existing and prospective investors regarding its eligibility for SEC registration, including that it served as an investment adviser to a registered investment company and managed as much as $1.5 billion in assets, when in fact, Delta was not an adviser to a registered investment company and at times managed no more than $9 million in assets. In addition, the SEC alleged that Delta failed to disclose its poor financial condition, a default judgment entered against it in a breach of fiduciary duty lawsuit brought by a client, and that Mr. Hanlon had been the subject of disciplinary action by FINRA. The SEC also alleged that Delta did not disclose its poor financial condition to clients, revise its Form ADV to

accurately reflect assets under management or deregister with the SEC, after being requested to do so by the staff of the SEC.

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This Regulatory Update is only a summary of recent information and should not be construed as legal advice.