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Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

CFTC Adopts Rule Amendments to Harmonize Compliance Obligations for Commodity Pool Operators of Registered Investment Companies

On August 13, 2013, the Commodity Futures Trading Commission (CFTC) adopted final regulations with respect to compliance obligations for commodity pool operators (CPOs) of registered investment companies. The final regulations (the Harmonization Rules) amend Part 4 of the CFTC's regulations in order to harmonize the disclosure, reporting and recordkeeping compliance obligations of the CFTC and SEC applicable to entities registered with both regulatory agencies. (In February 2012, the CFTC amended CFTC Rule 4.5, which modified the exclusion from the definition of a CPO for funds by imposing limitations on the use of certain commodity interests. For funds no longer able to claim the exclusion from the definition of a CPO, the investment adviser is now required to register with the CFTC, thus becoming subject to dual regulation.)

In the adopting release, the CFTC noted that it had received several comments regarding the relationship between the CFTC's regulations applicable to CPOs of funds and the SEC's rules and guidance applicable to funds, including that the two sets of requirements were duplicative, inconsistent and possibly conflicting. The Harmonization Rules provide CPOs of funds with the option to either comply with the requirements of Part 4 of the CFTC regulations or to choose "substituted compliance." Under the substituted compliance approach, the CFTC will accept compliance with the disclosure, reporting and recordkeeping regime of the SEC in place of the CPO's compliance with the CFTC's regulations. In order to utilize the substituted compliance approach, a fund's CPO must (1) file a notice with the National Futures Association (NFA) of its use of substituted compliance; and (2) file with the NFA a fund's financial statements prepared in connection with its SEC reporting obligations. In addition, a CPO of a fund with less than a three-year operating history must disclose the performance of all accounts and pools that are managed by the CPO and that have investment objectives, policies and strategies substantially similar to those of the fund.

The Harmonization Rules also provide an exemption from the CFTC requirement to periodically distribute account statements to each participant in a commodity pool provided that (1) the fund's current net asset value per share is available to investors; and (2) the fund provides annual and semi-annual reports to shareholders (and files the required reports with the SEC). The CFTC also amended its rules to permit all CPOs (not just CPOs to funds) to use third-party service providers for recordkeeping purposes. CPOs electing to use such third-party service providers must file a notice with the NFA providing information about the third-party service provider and a statement from the service provider agreeing to maintain the fund's books and records consistent with the CFTC's regulations.

The Harmonization Rules became effective on August 22, 2013, except for the disclosure exemptions and third-party recordkeeping amendments which became effective on September 23, 2013. The ICI has requested that the CFTC confirm that the compliance date for the Harmonization Rules is October 21, 2013 and the compliance date for the disclosure exemptions and third-party recordkeeping amendments is November 22, 2013.

Division of Investment Management Issues Guidance Regarding Certain Disclosure and Compliance Matters for Funds That Invest in Derivatives

In August 2013, the Staff of the Division of Investment Management of the SEC published a Guidance Update summarizing its views on certain disclosure and compliance matters relating to funds that are subject to regulation by both the SEC and CFTC because they invest in commodity derivatives. The Guidance Update was issued in conjunction with the CFTC's Harmonization Rules related to funds subject to both SEC and CFTC regulation. Among other topics, the Guidance Update notes the need for funds to (1) adequately disclose the principal investment strategies and risks associated with investments in derivatives; (2) ensure that performance presentations are not materially misleading; and (3) maintain an effective compliance and risk management function.

The Guidance Update emphasizes the importance for funds that use, or intend to use, derivatives to assess the accuracy and completeness of their disclosure, including whether it is presented in plain English. Specifically, the Staff highlights as relevant factors to be considered in determining the appropriateness of derivatives disclosure the nature, type and extent of derivatives used by a fund, including the degree of economic exposure created, and the purpose for using derivatives. The Staff recommends that a fund assess the completeness and accuracy of its derivatives-related disclosures in light of its actual operations on at least an annual basis.

The Guidance Update also elaborates on the Staff's previous guidance allowing a new fund, with no (or short) performance history, to include information in its prospectus concerning the performance of other private accounts or funds managed by the fund's adviser that have substantially similar investment objectives, policies and strategies as the fund so long as the information is not materially misleading. The Guidance Update reaffirms the position that a newly registered fund that invests in commodity derivatives may still include performance information of other funds or accounts managed by its adviser, but is responsible for ensuring that the information is not materially misleading. The Staff specifically notes that a fund should not exclude the performance of other substantially similar funds or private accounts if the exclusion would cause the performance to be materially higher or more favorable than if the funds or accounts were included.

The Guidance Update also highlights the importance of a fund's adviser and board, through its oversight role, in maintaining effective written policies and procedures reasonably designed to prevent material misstatements and to ensure proper management of derivatives and their associated risks. The Staff notes that, among other things, the policies and procedures should sufficiently address the accuracy of disclosures made about a fund's use of derivatives, as well as consistency of the fund's investments in these derivatives with its investment objectives. Finally, the Staff indicates that it would not object if funds that invest in commodity derivatives indicate in the legend required by Rule 481 under the Securities Act that the CFTC (as well as the SEC) has not approved or disapproved of the securities or passed upon the accuracy or adequacy of the disclosure in the prospectus.

SEC Adopts Rule Amendments to Implement JOBS Act Provisions for the Elimination of Prohibitions Against General Solicitation in Private Offerings

On July 10, 2013, the SEC adopted final amendments to Rule 506 of Regulation D and Rule 144A under the Securities Act in order to implement Section 201(a) of the Jumpstart Our Business Startups Act (JOBS Act). Section 201(a)(1) of the JOBS Act directed the SEC to eliminate the prohibition against general solicitation in private security offerings made under Rule 506 provided that all purchasers of the securities are accredited investors. New Rule 506(c) permits issuers to use general solicitation and general advertising in private security offerings made under Rule 506 provided that: (1) the issuer takes reasonable steps to verify that investors are accredited investors; (2) each investor qualifies, or the issuer reasonably believes that each investor qualifies, as an accredited investor at the time of the sale of securities; and (3) all terms and conditions of Rules 501, 502(a) and 502(d) are satisfied.

The SEC noted that whether the steps taken by an issuer to verify accredited investor status are "reasonable" is an objective determination based on the particular facts and circumstances of each investor and transaction. Factors to be considered in this analysis are:

(1) the nature of the purchaser and type of accredited investor that the purchaser claims to be;

(2) the amount and type of information that the issuer has about the purchaser; and

(3) the nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering, and the terms of the offering, such as the minimum investment amount.

In response to commenters' requests, Rule 506(c) also provides a non-exclusive list of specific methods that investors may use to verify an investor's accredited investor status. This list includes:

(1) with respect to verifying income, review copies of any IRS form that reports income (e.g., W-2, Form 1099 or a copy of a filed Form 1040), along with a written representation that the investor will likely continue to earn the necessary income in the current year;

(2) with respect to verifying net worth, review copies of bank statements, brokerage or other statements of securities holdings, or CDs for evidence of sufficient net worth, along with a credit report for evidence of total liabilities; or

(3) obtain a written confirmation from a broker-dealer, an investment adviser, a licensed attorney or a certified public accountant that such entity or person has taken reasonable steps to verify the investor's accredited investor status.

Section 201(a)(1) of the JOBS Act also directed the SEC to revise Rule 144A(d)(1) to provide that securities resold pursuant to Rule 144A may be offered, including by means of general solicitation, to persons other than qualified institutional buyers (QIBs) as long as the securities are sold only to persons that the seller and any person acting on behalf of the seller reasonably believe is a QIB. The SEC adopted amendments to Rule 144A as directed under the JOBS Act.

The rule amendments became effective on September 23, 2013.

SEC Adopts Rule Amendments to Disqualify Felons and Other "Bad Actors" from Rule 506 Private Offerings

On July 10, 2013, the SEC adopted final amendments to Rule 506 of Regulation D under the Securities Act to disqualify issuers from relying on the Rule with respect to an offering if the issuer or certain other "covered persons" are subject to a "disqualifying event."

The rule amendments apply to all "covered persons," which include:

(1) the issuer and any predecessors and affiliated issuers;

(2) directors, executive officers, general partners or managing members of the issuer;

(3) officers of the issuer who are not executive officers but who are participating in the offering;

(4) beneficial owners of 20% or more of the issuer's outstanding voting equity securities;

(5) promoters connected with the issuer in any capacity at the time of a sale in the offering;

(6) persons compensated for the solicitation of purchasers in connection with the sale of securities in the offering (or any general partner, managing member, director or executive officer of such solicitor); and

(7) any investment manager of an issuer that is a pooled investment fund (or any general partner, managing member, director or executive officer of such investment manager).

The rule amendments identify various "disqualifying events" and any timeframe applicable to such events. Disqualifying events generally include:

(1) criminal convictions, court injunctions and restraining orders in connection with the purchase or sale of a security, making of a false filing with the SEC or arising out of the conduct of certain types of financial intermediaries;

(2) final orders from the Commodity Futures Trading Commission, federal banking agencies and certain other federal and state financial regulatory entities, that bar the issuer from associating with a regulated entity, engaging in certain activities, or are based on fraudulent, manipulative, or deceptive conduct;

(3) certain SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment companies, and investment advisers and their associated persons;

(4) SEC cease-and-desist orders related to violations of certain anti-fraud provisions and registration requirements of the federal securities laws;

(5) certain SEC stop orders and orders suspending the Regulation A exemption;

(6) suspension or expulsion from membership in a self-regulatory organization (SRO) or from association with an SRO member; and

(7) U.S. Postal Service false representation orders.

As adopted, disqualification applies only for disqualifying events that occur after the effective date of the rule amendments. However, matters that existed before the effective date that would otherwise be disqualifying must be disclosed in writing to investors a reasonable time prior to the sale. In addition, an issuer will not be disqualified from relying on Rule 506 when it can show it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering.

The rule amendments became effective on September 23, 2013.

SEC Proposes Additional Amendments to Form D, Regulation D and Rule 156 Under the Securities Act

In connection with the final amendments adopted to Rule 506, the SEC proposed additional amendments to Form D, Regulation D and Rule 156 under the Securities Act to allow it to monitor Rule 506 offerings and to address issues that arise in connection with allowing general solicitation and general advertising for such offerings. Specifically, the SEC proposed to increase the informational requirements of Form D by amending several items and adding new items. The SEC proposed to require filing of Form D no later than 15 days prior to the first use of general solicitation in a Rule 506 offering and filing of a closing Form D amendment no later than 30 days after the termination of a Rule 506 offering. Also, the signature block on Form D would be revised to include a certification by issuers that the offering is not disqualified from reliance on Rule 506.

In addition to the proposed changes to Form D, the SEC proposed further amendments to Regulation D, including:

- an amendment to Rule 507 to disqualify an issuer from relying on Rule 506 for one year if the issuer, or any predecessor or affiliate of the issuer did not comply within the last five years with all of the Form D filing requirements for a Rule 506 offering;
- new Rule 509 to require issuers to include prescribed legends in any general solicitation materials informing potential investors as to whether they are qualified to participate in the offering, the type of offering being conducted and the risks associated with the offering. Private funds also would be required to include a legend disclosing that securities being offered are not subject to the 1940 Act and to include additional disclosures in solicitation materials that include performance data. New Rule 509 would disqualify an issuer from relying on Rule 506 if such issuer or its predecessor has been subject to a court order enjoining it for failure to comply with Rule 509; and
- new Rule 510T to require issuers to temporarily submit their general solicitation materials to the SEC on a non-public basis.

Finally, the SEC proposed to amend Rule 156 under the Securities Act (the rule applicable to investment company sales literature) to apply to sales literature used by private funds in Rule 506 offerings.

Comments on the proposed amendments are due by November 4, 2013.

Other News

SEC's Office of Compliance Inspections and Examinations Issues Risk Alert on Advisers' Business Continuity and Disaster Recovery Planning

On August 27, 2013, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert on business continuity and disaster recovery planning for investment advisers after reviewing responses to the widespread market disruptions caused by Hurricane Sandy last October. Following the two-day closure of the equity and options markets, OCIE examined approximately 40 investment advisers to assess their preparedness for, and reaction to, the storm.

OCIE's Risk Alert encourages investment advisers to review their business continuity plans to improve response and recovery time after significant large-scale events. The Risk Alert specifically identifies six areas that investment advisers may consider reviewing to strengthen their current plans: (1) preparation for widespread disruption; (2) planning for alternative locations; (3) preparedness of key vendors; (4) telecommunications services and technology; (5) communication plans; and (6) reviewing and testing.

PCAOB Proposes Changes to the Auditor's Reporting Model

On August 13, 2013, the PCAOB proposed two new auditing standards to enhance the auditor's reporting model. Each proposed standard would require additional disclosure in the auditor's report. The first would require auditors to communicate "critical audit matters" addressed during the audit along with other information about the auditor and its responsibilities. The second would require auditors to report on their evaluation of "other information" in a company's annual report filed with the SEC.

The first proposed standard retains the pass/fail model of the current auditor's report, but would require the auditor to communicate a wider range of information about the audit. The proposed requirements include:

- communication of critical audit matters as determined by the auditor;
- enhancements to existing language in the auditor's report relating to the auditor's responsibilities for fraud and notes to the financial statements; and
- new disclosures related to auditor independence, auditor tenure and the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

Under the proposal, critical audit matters would include those audit matters that (1) involved the most difficult, subjective or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

The second proposed standard would enhance the auditor's responsibilities and communications with respect to "other information" in a company's annual report outside of the financial statements. The proposed standard would:

- specify that the auditor's responsibilities for other information apply to a company's annual report filed with the SEC that contains the company's audited financial statements and the related auditor's report;
- enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating other information;
- require the auditor to evaluate the other information for a material misstatement of fact or for a material inconsistency; and
- require the auditor to communicate in the auditor's report the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

As proposed, the two new standards would apply to audits of investment companies, but the PCAOB's proposal seeks comment on whether the proposed changes to auditing standards are appropriate for investment company audits, and whether there are any considerations with respect to affiliated investment companies, master-feeder funds or fund of funds that the PCAOB should consider.

Comments are due by December 11, 2013. The proposed standards would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015.

SEC Commissioner Gallagher Discusses the Need for Proxy Advisory Service Reform

In a July 11, 2013 speech to the Society of Corporate Secretaries & Governance Professionals, SEC Commissioner Daniel Gallagher expressed concerns about whether investment advisers are fulfilling their fiduciary duties to investors when they rely on, and follow, proxy advisory firm recommendations. Commissioner Gallagher stated that investment advisers may view their proxy voting responsibilities with more of a compliance mindset than a fiduciary mindset. He attributed this shift in voting practices, in part, to two SEC staff no-action letters issued in 2004 that provide a potential safe harbor against claims of conflicts of interest when an investment adviser votes client proxies based on the recommendations of an independent third party, even though the recommendations may be consistent with the investment adviser's own interests.

Commissioner Gallagher concluded his speech by stating that the no-action letters should be replaced with SEC-level guidance to ensure that investment advisers "take responsibility for their voting decisions rather than engaging in rote reliance on proxy advisory firm recommendations." In addition, he suggested that the SEC undertake a fundamental review of the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring a universal code of conduct, ensuring recommendations are designed to increase shareholder value, increasing transparency and overall accountability and ensuring that conflicts of interests are appropriately dealt with.

Litigation and Enforcement Actions

Massachusetts Supreme Court Clarifies Annual Shareholder Meeting Requirement

On September 11, 2013, the Supreme Judicial Court of Massachusetts provided its interpretation of a provision in the bylaws of two closed-end PIMCO funds requiring that annual shareholder meetings be held "on at least an annual basis." The court held that the phrase required the funds to hold their annual meetings no later than one year and 30 days following the previous year's annual meeting.

At issue in the case was the interpretation of a provision in the funds' bylaws relating to the timing of the funds' annual shareholder meetings. Specifically, the funds' bylaws provide that, so long as common shares of the funds are listed on the NYSE, "regular meetings of the Shareholders for the election of Trustees…shall be held…on at least an annual basis." The plaintiffs, the second-largest beneficial owners of the funds' preferred shares, sued the funds after the funds rescheduled their annual meetings from December 2011 to July 31, 2012 subsequent to receiving notice that the plaintiffs intended to nominate one of their partners for election as a preferred shares trustee. The plaintiffs argued that the bylaws required the funds to hold their annual shareholders' meetings within 12 months of the previous year's annual meeting, which was held in December 2010, and that the funds' failure to do so delayed the plaintiffs' ability to elect their nominee as a preferred shares trustee. The funds argued that the bylaws, in conjunction with the NYSE rules, merely required that an annual shareholders' meeting be held in each fiscal year, with July 31, 2012 being the last day of each fund's fiscal year.

The Superior Court granted summary judgment to the plaintiffs, ordering that the funds hold the annual meeting "as soon as practicable" and endorsing the plaintiffs' interpretation of the bylaws. The Appeals Court stayed the judgment, and the annual meeting was held, as rescheduled, on July 31, 2012. On its own motion, the Supreme Judicial Court reviewed the appeal with respect to the application of the bylaws to future annual meetings and modified the Superior Court's interpretation of the bylaws. The Supreme Judicial Court focused on the advanced notice provisions of the funds' bylaws, which included special notice requirements for "annual meetings" held more than 30 days before or after the anniversary of the previous year's annual meeting. The court noted that, for purposes of the advanced notice provisions only, the term "annual meeting" was defined to include special meetings held "in lieu of" annual meetings pursuant to a provision of the bylaws that authorizes the trustees to call such a special meeting if a "regular meeting of the Shareholders for the election of Trustees" is not held "in any annual period." The court interpreted these provisions as together suggesting that a "regular" annual meeting must be held within the "annual period" ending 30 days after the anniversary date of the previous year's meeting and that any "annual meeting" held thereafter would not be a "regular" annual meeting but rather a special meeting held "in lieu of" an annual meeting. The court noted that its interpretation was consistent with how the funds operated in previous years and that, to the extent that bylaws contain any ambiguity, the ambiguous provisions should be construed against the drafters.

Complaint Filed Against ING Investments Alleging Excessive Management Fees

On August 30, 2013, a shareholder of the ING Global Real Estate Fund filed a derivative action against ING Investments, LLC, investment adviser to the fund, in the U.S. District Court for the District of Delaware alleging that ING breached its fiduciary duty under Section 36(b) of the 1940 Act by charging an investment management fee so disproportionately large that it bore no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining. The plaintiff alleges that the nature and quality of the services provided to the fund did not justify the fee paid to ING because ING delegated "substantially all" of its investment management responsibilities to CBRE Clarion Securities LLC, the sub-adviser, while paying CBRE "just a fraction" of the total fee charged to the fund (allegedly $12.1 million out of $27.6 million in fiscal year 2012). The plaintiff also alleges that economies of scale enjoyed by ING in connection with the provision of investment management services were not passed on to the fund as required by Section 36(b). To support this allegation, the plaintiff cites ING's failure to implement additional fee breakpoints despite the fact that the fund reached its final breakpoint of $500 million in October 2006 and, as of April 30, 2013, had net assets of approximately $5.4 billion. The plaintiff notes that CBRE's breakpoint schedule includes a final breakpoint at $750 million and claims that ING used the disparity with its breakpoint schedule to benefit itself rather than the fund. Finally, the plaintiff asserts that no "truly independent board acting conscientiously" with adequate information would have tolerated ING's fees, alleging that the fund's trustees violated their fiduciary duty to the fund and its shareholders by rubber-stamping the investment management agreement. The plaintiff seeks actual damages resulting from the excessive fees or, alternatively, rescission of the investment management agreement and restitution of all excessive fees paid pursuant thereto.

District Court Dismisses Complaint Against BlackRock and iShares for Excessive Securities Lending Fees

On August 28, 2013, the U.S. District Court for the Middle District of Tennessee dismissed without prejudice a derivative suit filed by two union pension plans against BlackRock Fund Advisors (BFA), BlackRock Institutional Trust Company, N.A. (BTC), iShares, Inc., iShares Trust and the directors and trustees, including the independent directors and trustees, of iShares, Inc. and iShares Trust. The complaint alleged that BFA and BTC, the iShares funds' investment adviser and securities lending agent, respectively, violated Sections 36(b), 47(b) and 36(a) of the 1940 Act by charging "grossly excessive" fees in connection with the lending of the funds' securities, detracting from the funds' returns. The plaintiffs sought an injunction against continued securities lending, recovery of excessive compensation, rescission of the securities lending agreements and additional damages.

In granting the defendants' motions to dismiss, the district court first rejected the plaintiffs' claim for relief under Section 36(b), which creates a private right of action to seek relief from breaches of fiduciary duty resulting in excessive compensation. The district court ruled that because the defendants' securities lending arrangements were authorized by an exemptive order under Section 17 of the 1940 Act, the securities lending transactions were outside the scope of Section 36(b) because Section 36(b)(4) expressly states that Section 36(b) "shall not apply to compensation or payments made in connection with transactions subject to [Section 17 of the 1940 Act] or rules, regulations or orders thereunder." With respect to plaintiffs' claims under Sections 47(b) and 36(a), the district court ruled that neither statute creates a private right of action because both lack the "rights-creating language" necessary to do so under Supreme Court precedent. The district court noted that Section 47(b) merely creates a remedy for the enforcement of predicate rights of action created elsewhere in the 1940 Act. The district court ruled that the plaintiffs' claims could not be enforced under Section 47(b) because the Section 36(b) claim was foreclosed by Section 36(b)(4) and the other alleged violations, including that of Section 36(a), did not involve 1940 Act provisions that created private rights of action.

SEC Sanctions Portfolio Manager for Forging Documents and Misleading Chief Compliance Officer

On August 27, 2013, the SEC settled charges against Carl Johns, a former assistant portfolio manager with Boulder Investment Advisers, LLC (Boulder), for violations of Section 17(j) of the 1940 Act and Rules 17j-1(b), 17j-1(d) and 38a-1(c) thereunder. The SEC found that, from 2006 to 2010, Mr. Johns engaged in active personal trading in securities without pre-clearing or reporting a majority of his trades. The SEC found that Mr. Johns concealed his personal securities transactions by altering brokerage statements attached to quarterly and annual trading reports and falsely certifying to compliance with Boulder's code of ethics. The SEC's order stated that, during the chief compliance officer's investigation, Mr. Johns misled the chief compliance officer by creating false pre-clearance documents and backdating personal securities transactions. Mr. Johns agreed to pay disgorgement of $231,169, prejudgment interest of $23,889 and a civil monetary penalty of $100,000. Mr. Johns was also barred from the securities industry for at least five years. The settlement with Mr. Johns marks the first ever enforcement action by the SEC under Rule 38a-1(c), which prohibits an officer, director or employee of a fund or its investment adviser from taking any action to coerce, manipulate, mislead or fraudulently influence the fund's chief compliance officer.

SEC Charges Investment Adviser for Misleading Fund Board During 15(c) Process

On August 21, 2013, the SEC filed an order instituting enforcement proceedings against Chariot Advisors LLC (Chariot), a North Carolina-based investment adviser, and Elliot Shifman, Chariot's former owner, alleging that Chariot and Mr. Shifman misled the Board of Trustees of the Northern Lights Variable Trust in connection with the Board's review of Chariot's proposed advisory contract with the Chariot Absolute Return Currency Portfolio, a newly created fund. The SEC's order alleges that Chariot and Mr. Shifman misled the Board about Chariot's ability to conduct algorithmic currency trading as part of the fund's proposed investment strategy. The SEC's order states that Mr. Shifman represented to the Board that Chariot would use an algorithmic model to perform currency trading on behalf of the fund, but Chariot did not devise or otherwise possess any algorithmic models to carry on this type of trading. The SEC's order further states that even though Mr. Shifman thought that the fund's currency trading needed to achieve a 25-30% return to succeed, he never disclosed to the Board that Chariot did not have an algorithm or model capable of generating such returns. Instead, the SEC alleges that Chariot's currency trading was done by an individual trader who was allowed to use her discretion on trade selection and execution. The SEC's order alleges that Chariot's ability to trade currency based on an algorithmic model was important to the Board because, in the absence of an operating history of the fund, the Board focused on Chariot's reliance on the model to evaluate Chariot's proposed advisory contract with the fund.

The SEC's order alleges that the misrepresentations by Chariot and Mr. Shifman resulted in violations of Sections 15(c) and 34(b) of the 1940 Act and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

Seventh Circuit Seeks Clarification Regarding Insider Trading Prohibitions and Mutual Fund Redemptions

On July 22, 2013, the U.S. Court of Appeals for the Seventh Circuit reversed the district court ruling in Securities and Exchange Commission v. Bauer and remanded for further proceedings to consider the novel issue of whether and how the "misappropriation theory" of insider trading applies to mutual fund redemptions.

In the fall of 2000, Jilaine H. Bauer (the Defendant) served as general counsel, chief compliance officer, and chairperson of the pricing committee for Heartland Advisors, Inc. (HAI). The Defendant also served as vice president and secretary of Heartland Group, Inc. (HGI), an open-end investment company. HAI was the investment adviser, principal underwriter and distributor for the HGI mutual funds, including the Short Duration Fund and the High Yield Fund (the Funds). Beginning in 1999 and continuing through October 2000, the Funds experienced substantial net redemptions, resulting in significant decreases in NAV and increased illiquidity. In addition, several of the Funds' portfolio securities had defaulted or were in danger of default. In order to generate the cash required to meet redemption demands, the Funds began selling off securities at discounted prices. The Defendant redeemed all of her shares in the Short Duration Fund on October 3, 2000. Ten days later, HAI's pricing committee instituted across-the-board "haircuts" on the Funds' securities, resulting in NAV decreases of 44.02% and 69.41% for the two Funds, which entered receivership five months later.

On December 11, 2003, the SEC charged the Defendant with insider trading, and on May 25, 2011, the U.S. District Court for the Eastern District of Wisconsin granted summary judgment to the SEC under the "classical theory" of insider trading, which "targets a corporate insider's breach of duty to shareholders with whom the insider transacts." On appeal, the Defendant argued that the "classical theory" is inapplicable to mutual fund redemptions because the trading counterparty—the mutual fund itself—is inherently fully informed and "cannot be duped through nondisclosure." Perhaps in response to this argument, the SEC abandoned the "classical theory" on appeal, instead arguing that the Defendant was liable under the "misappropriation theory" of insider trading whereby the disclosure obligation "runs to the source of the information" rather than the trading counterparty. In reversing the district court's order of summary judgment, the Seventh Circuit found that the lower court did not "weigh the novelty of the SEC's claims in the mutual fund context" because the SEC had not asserted the "misappropriation theory" of insider trading at the district court level. The Seventh Circuit remanded for further proceedings to consider the applicability of the "misappropriation theory" to the Defendant's redemptions and to resolve questions of fact related to the materiality of the Defendant's non-public information and whether the Defendant acted with scienter.

Second Circuit Affirms Dismissal of Class Action Against ProShares ETFs

On July 22, 2013, the U.S. Court of Appeals for the Second Circuit affirmed the dismissal of a class action lawsuit against ProShares Trust and ProShares Trust II (ProShares) in In re ProShares Trust Securities Litigation. The plaintiffs were investors in leveraged ProShares exchange-traded funds (the ETFs), each of which pursued an investment objective whereby it sought a return equal to a stated multiple of a benchmark index on a daily basis. The complaint alleged that the plaintiffs suffered losses due to ProShares' failure—in violation of Sections 11 and 15 of the Securities Act—to adequately disclose the risks of holding investments in the ETFs for periods longer than one day.

Affirming the ruling of the U.S. District Court for the Southern District of New York, the Second Circuit found that ProShares adequately disclosed the risks of long-term investments in the ETFs. The court rejected the plaintiffs' primary argument that ProShares made a material omission by not disclosing that an ETF investor could experience an "actual loss" despite correctly predicting the direction of the underlying index's movement over the period of investment. The court found that the disclosure clearly contemplated this scenario by stating that the value of a long-term investment in an ETF may "diverge significantly" from the value of the underlying index. Given the robust risk disclosure contained throughout the registration statements, the court found it implausible that the decision of a reasonable investor would be influenced by the allegedly material omission. The court further stated that subsequent disclosure revisions, which clarified that volatility could cause an investment in an ETF to "move in [the] opposite direction as the index," did not constitute an admission of the inadequacy of the prior disclosure. The plaintiffs also alleged that ProShares possessed an "undisclosed mathematical formula" and was aware that certain market conditions could place long-term ETF investors in a "must lose" position. In dismissing this allegation, the Second Court noted that ProShares "cannot be expected to predict and disclose all possible negative results across any market scenario."

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