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November 1, 2013

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 compliance date for the Harmonization Rules was 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.

Other News

Independent Directors Council Issues Guidance on Board Composition Considerations

In October 2013, the Independent Directors Council issued a whitepaper to assist fund directors when assessing board composition and related governance issues, including whether the board is properly constituted to perform its oversight role. The paper focuses on various topics, including: (i) recruitment and director selection; (ii) integration of new board members; (iii) continuing education; (iv) board mergers and consolidations; (v) self-assessments; (vi) length of service; and (vii) succession planning.

Recruitment and Director Selection

The paper notes that independent directors generally are required to select and nominate other independent directors and that funds are required to disclose the specific experience, qualifications, attributes or skills that led the board to conclude that an individual should serve as a fund director. Although emphasizing that board practices vary, the paper states that in selecting a new board member, the board should define the search criteria, focusing on the board's existing strengths and weaknesses to identify candidates who would complement the current board, and may consider, among other factors, the candidate's independence, fund industry, board, financial industry, risk management and governance experience, employment status, age, geographic location and diversity. After defining the search criteria, the board may look to multiple sources to suggest potential candidates, including board committees, the independent directors, the full board, fund management, shareholders, outside counsel, an executive search or recruiting firm or independent auditors.

Integration of New Board Members

The paper encourages orientation for new directors during which various topics may be addressed, including the board and its governance practices, the funds and their investment strategies, fund operations, the role and responsibilities of board members under federal and state laws, insurance and indemnification arrangements and legal and regulatory matters affecting the funds. The paper states that boards approach a new director's transition onto the board in various ways and may include overlapping the service of a new director with that of a retiring director, appointing the new director to an advisory board position prior to joining the board as a director and electing the new director for a short initial term before being eligible for reelection. The paper also indicates that boards may wish to consider the timing of when a new director joins the board, noting that a board may determine that a new director's first meeting should be a meeting other than the annual contract renewal meeting.

Continuing Education

The paper cites various methods in which directors may continue their fund education, including receiving reports from management, outside counsel and other fund service providers, subscribing to industry publications and attending educational seminars.

Board Mergers and Consolidations

The paper reviews various factors boards may consider if faced with board mergers and consolidations. In addition to addressing how the boards will be combined, the paper states that insurance coverage for outgoing directors should be considered and, in some circumstances, the fund or management may determine to pay additional compensation to the outgoing directors.

Self-Assessments

Again emphasizing that board practices may vary, the paper offers points for boards to consider in designing their self-assessments, which boards typically conduct annually. These points include (i) various topics the self-assessments may cover, (ii) the process by which the self-assessment may be conducted, including verbally or in writing, (iii) whether to conduct peer reviews, (iv) whether to perform self-assessments at the committee level, and (v) whether to solicit input from other persons, such as the fund's chief compliance officer.

Length of Service

The paper states that an increasing number of boards have mandatory retirement policies and the average mandatory retirement age is 74. The paper discusses potential benefits and drawbacks to limiting director terms or to having a mandatory retirement policy and items for boards to consider in determining whether to adopt or modify term limits or a mandatory retirement policy.

Succession Planning

The paper states that boards may wish to adopt a succession plan for board members, board chairs and committee chairs, and states that among other factors, a board may consider the key attributes of an outgoing director, whether to appoint the outgoing director as a nonvoting board member for a period of time and whether to designate a successor for an overlapping period.

The paper is available at: http://www.idc.org/pdf/pub_13_considerations_board_comp.pdf

Independent Directors Council Issues Guidance on Investment Performance Oversight by Fund Boards

In October 2013, the Independent Directors Council issued a whitepaper to assist fund directors in overseeing a fund's portfolio structure and risks and its performance results. The paper focuses on various topics, including: (i) understanding the characteristics and performance expectations of a fund; (ii) understanding the adviser's investment organization and processes; (iii) reviewing a fund's performance on an ongoing basis; and (iv) addressing performance issues.

Understanding the Characteristics and Performance Expectations of a Fund

The paper states that boards should understand a fund's key investment characteristics and how they correlate with the fund's benchmarks and expectations for performance and risks relative to those benchmarks. Fund advisers should provide boards with such information at the time of fund formation and on an ongoing basis. In particular, boards should understand a fund's investment objectives and principal investment strategies; the rationale for selecting a fund's benchmark or benchmarks; expectations for when and why a fund's returns may differ from its peer group; the degree to which the adviser is using active management, including how that may affect portfolio turnover and transaction costs; and whether the adviser has adopted investment guidelines in addition to the fund's investment strategies as set forth in its prospectus and statement of additional information.

Understanding the Adviser's Investment Organization and Processes

Among other oversight responsibilities, the paper states that board oversight includes understanding the adviser's processes for: (i) selecting fund portfolio managers, including the portfolio managers' experience and performance records for the investment mandate to be used by a fund, (ii) monitoring a fund's portfolio structure, including the adviser's risk management processes, and (iii) evaluating fund performance. The paper indicates that boards also should understand the qualifications and roles of research analysts, traders and other personnel who are involved with the investment process. In addition, the paper encourages boards to be aware of the portfolio manager compensation methodology and the adviser's succession plan for key portfolio managers.

Reviewing a Fund's Performance on an Ongoing Basis

The paper states that the board and the adviser should agree on the format, content and frequency of performance reports, noting that boards generally receive oral and written performance reports at each board meeting and may receive more frequent informal summaries. As part of its oversight, the board should evaluate a fund's performance, as well as whether the fund is being managed consistent with its investment mandate. To accomplish this, board reports may include commentary and analysis regarding the portfolio managers' primary investment decisions, a fund's performance relative to its benchmarks and the impact of relevant market and economic events. Performance reports may include components such as executive summaries, fund dashboards and performance attribution reports. Depending on the structure of the board, the in-depth investment and performance review may be conducted by board committees or by the full board. In addition to reviewing fund performance at each board meeting, for larger fund complexes, a board may determine to focus on a sub-set of the funds (e.g., fixed income funds) at designated meetings throughout the year.

Addressing Performance Issues

The paper discusses the methods by which boards and advisers may address performance issues, noting that some fund groups may address performance issues on a case-by-case basis while others may have a process for monitoring performance, such as a fund "watch-list." Regardless of the approach, the board and adviser should discuss whether a performance issue appears to be temporary and the adviser's process for monitoring and any remediation plans. The paper cites possible solutions for long-term performance issues such as making fund investment strategy changes, replacing the fund's portfolio managers, hiring an external sub-adviser or merging or closing the fund.

The paper is available at: http://www.idc.org/pdf/pub_13_performance_oversight.pdf

Director of the Division of Investment Management Discusses Division Improvement Initiatives

In a recent speech at the Independent Directors Council's 2013 fall meeting, Norm Champ, the Director of the SEC's Division of Investment Management, discussed current initiatives to improve the effectiveness of the Division's oversight function, including the newly created Risk and Examinations Office or "REO." Mr. Champ described REO as a multi-disciplinary office staffed with quantitative analysts, examiners, lawyers and accountants that is expected to support the Division's work through two primary functions: (i) maintaining an industry monitoring program that provides ongoing financial analysis of the investment management industry and (ii) conducting an examination program that gathers additional information from the investment management industry to inform the Division's policy making. He stated that the Division's expectation is that REO will make the Division's oversight more efficient and effective and will help the Division "get out in front of industry trends, rather than reacting to past practices." Mr. Champ also discussed the various tools that can be employed by REO, including conducting its own examinations, and noted that the Division is considering potential changes to current industry reporting forms and the outdated technology supporting those forms to enhance REO's ability to collect and analyze data. The full text of Mr. Champ's remarks can be found at: http://www.sec.gov/News/Speech/Detail/Speech/1370540048684

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.

Litigation and Enforcement Actions

SEC Sanctions Three Investment Advisory Firms for Violating Custody Rule

On October 28, 2013, the SEC sanctioned Further Lane Asset Management, LLC (FLAM), GW & Wade, LLC (GW & Wade) and Knelman Asset Management Group, LLC (KAMG) for, among other violations, failing to maintain custody of their clients' funds and securities in accordance with Rule 206(4)-2 under the Advisers Act.

The SEC's order against FLAM found that FLAM maintained custody of the assets of the hedge funds it managed, but that FLAM failed to arrange for annual surprise examinations to verify the hedge funds' assets or for investors to receive quarterly account statements from the hedge funds' qualified custodian. FLAM agreed to pay $347,122 in disgorgement and prejudgment interest, and its chief executive officer agreed to pay a $150,000 civil monetary penalty and be suspended from the industry for one year. FLAM also agreed to undertake certain compliance-related actions, including retaining a compliance consultant.

The SEC's order against GW & Wade found that GW & Wade had custody of client assets that it could access and transfer to third parties, but that GW & Wade failed to obtain an examination by an independent public accountant and to identify such assets in its public disclosures. The SEC found that GW & Wade's policies and procedures for its custody arrangements were inadequate and contributed to a third-party's fraudulent withdrawal of $290,000 from one client's account. GW & Wade refunded the amount to the harmed client and agreed to pay a $250,000 civil monetary penalty. GW & Wade also agreed to undertake certain compliance-related actions, including retaining a compliance consultant.

The SEC's order against KAMG found that KAMG maintained custody of the assets of a fund of private equity funds it managed, but failed to arrange for annual surprise examinations to verify the fund's assets, or alternatively, to provide investors with audited financial statements for the fund. KAMG agreed to pay a $60,000 civil monetary penalty, and its chief executive officer (who also served as KAMG's chief compliance officer) agreed to pay a $75,000 civil monetary penalty and be barred from acting as a chief compliance officer for three years. KAMG also agreed to undertake certain compliance-related actions, including retaining a compliance consultant.

SEC Sanctions Three Investment Advisory Firms Under Compliance Program Initiative

On October 23, 2013, the SEC sanctioned Modern Portfolio Management, Inc. (MPM), Equitas Capital Advisers, LLC and Equitas Partners, LLC (collectively, the Equitas firms), and certain of their owners and officers for repeatedly ignoring problems with their compliance programs. The three investment advisory firms were identified through the SEC's Compliance Program Initiative, which targets firms that previously have been warned by the SEC's examination staff about significant deficiencies in their compliance programs but have failed to take action to effectively remedy the identified compliance problems.

The SEC's order against MPM found that MPM and its owners failed to complete the annual compliance review required by Rule 206(4)-7 under the Advisers Act in 2006 and 2009 and made misleading statements on its website and in its Form ADV. The SEC order stated that these violations continued after being identified through SEC examinations in 2008 and 2011. MPM and its owners agreed to pay a total of $175,000 in civil monetary penalties. In addition, MPM undertook to retain a compliance consultant for three years and its owners agreed to complete additional compliance training.

The SEC's order against the Equitas firms found that, for the period from 2005 through 2011, the Equitas firms and their owner, chief compliance officer, and former owner and chief compliance officer failed to adopt and implement written compliance policies and procedures and conduct the annual compliance reviews required by Rule 206(4)-7 under the Advisers Act. The SEC also found that the Equitas firms made false and misleading disclosures about past performance, compensation and conflicts of interest and consistently overbilled and underbilled their clients. The SEC order stated that these violations occurred despite warnings from the SEC examination staff in connection with examinations conducted in 2005, 2008 and 2011. The Equitas firms and their current and former owners agreed to pay a total of $225,000 in civil monetary penalties. In addition, the Equitas firms undertook to retain a compliance consultant for three years.

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.

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

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Investment Services Group

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