November 3, 2014

Investment Services Regulatory Update

New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Guidance Regarding Mixed and Shared Funding Orders

In October 2014, the staff of the Division of Investment Management of the SEC published a Guidance Update addressing whether a fund that offers its shares under a variable life and/or variable annuity contract is required to obtain a "mixed and shared funding" order prior to making such offer or, if an order previously has been obtained, whether a fund needs to comply with the terms and conditions of the order if the exemptions from the 1940 Act granted thereunder are not being relied upon.

In the Guidance Update, the staff notes that neither "mixed funding"—the sale of shares of a fund to various types of offerees (e.g., variable insurance contracts and retirement plans)—nor "shared funding"—the sale of shares of a fund as an investment option in variable insurance contracts issued by multiple unaffiliated insurance companies—is prohibited by the 1940 Act, but that insurance companies and their affiliates that seek to rely on certain SEC rules providing exemptions from Sections 9(a), 13(a) and 15(a) and (b) of the 1940 Act must comply with restrictions on mixed and shared funding. The staff further notes that, although many funds have sought and received mixed and shared funding orders to allow insurance companies and their affiliates to rely on the exemptions from Sections 9(a), 13(a) and 15(a) and (b) without complying with the restrictions on mixed and shared funding, such exemptions are very infrequently relied upon.

In light of the infrequent reliance, the staff states that: (1) a fund is not required to obtain a mixed and shared funding order prior to offering its shares as an investment option in one or more variable insurance contracts, but an insurance company and its affiliates will not have the exemptions typically granted by the orders, and (2) compliance with the terms and conditions of a previously issued order is not required if no insurance company or its affiliates are relying on the exemptions granted thereunder. The staff also notes in the Guidance Update that participation agreements between insurance companies and funds may require compliance with the terms and conditions of a fund's mixed and shared funding order and that insurance companies and funds may want to revise the terms of their participation agreements to eliminate such requirements if the insurance companies are not relying on the exemptions granted under the orders.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2014-10.pdf.

Division of Investment Management Issues Guidance on the Presentation of Consolidated Financial Statements

In October 2014, the Chief Accountant's Office of the Division of Investment Management of the SEC published a Guidance Update regarding the presentation of consolidated financial statements for feeder funds, funds of funds and business development companies (BDCs).

For feeder funds, the Guidance Update notes that the Chief Accountant's Office generally has taken the position that, because feeder funds are typically one of several investors in a master fund, unconsolidated financial statements for feeder funds are the most meaningful presentation, provided that, among other things: (1) a feeder fund attaches

the financial statements of the master fund to its financial statements; (2) if a master fund is organized as a partnership, the feeder fund separately discloses on its statement of operations the net investment income, net realized gain or loss, and net change in unrealized gain or loss allocated from the master fund; and (3) if a master fund is organized as a partnership, the feeder fund includes the net investment income and expenses allocated from the master fund in its net investment income and expense ratios in its financial highlights.

For funds of funds, the Guidance Update notes that the Chief Accountant's Office has taken the position that, because funds of funds typically invest in multiple underlying funds, unconsolidated financial statements for funds of funds are the most meaningful presentation. The Guidance Update notes that a fund of funds should consider whether investment in any single underlying fund is so significant to the fund of funds that its financial statements should be presented in a manner similar to the presentation by feeder funds.

For BDCs, the Guidance Update states that a number of BDCs have wholly-owned subsidiaries, but do not consolidate such subsidiaries even though the design and purpose of the subsidiary may be to act as an extension of the BDC's investment operations. The Guidance Update suggests that BDCs consolidate such subsidiaries, because the consolidation will provide investors with the most meaningful financial statements.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2014-11.pdf.

SEC Proposes Extending Temporary Rule Regarding Adviser Principal Trades

On August 12, 2014, the SEC proposed an amendment to Rule 206(3)-3T to extend the Rule's expiration date by two years until December 31, 2016. The temporary Rule provides an alternative method for investment advisers, who are also broker-dealers, to comply with Section 206(3) of the Advisers Act, which requires an adviser to obtain client consent prior to engaging in a principal transaction with the client. Rule 206(3)-3T was initially adopted on September 24, 2007 in response to a federal appeals court decision that vacated Rule 202(a)(11)-1 of the Advisers Act, which allowed registered broker-dealers to offer fee-based accounts without being regulated as investment advisers. On December 20, 2012, the SEC extended Rule 206(3)-3T until December 31, 2014. Pursuant to Rule 206(3)-3T, if an adviser enters into a principal trade with a client, the adviser will be deemed to comply with Section 206(3) if the adviser, among other things: (1) obtains written, revocable consent from the client prospectively authorizing principal trades; (2) provides written prospective disclosure regarding the conflicts arising from principal trades; (3) provides certain disclosures, either oral or written, and obtains client consent prior to each principal trade; (4) provides the client with an annual report on all principal transactions with that client and (5) sends confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction. The Rule applies only to non-discretionary accounts of investment advisers who are also registered as broker-dealers and the accounts also must be brokerage accounts subject to the Exchange Act. The Rule applies to all accounts meeting the above requirements, whether or not they were previously fee-based brokerage accounts.

The SEC proposed no changes to Rule 206(3)-3T other than the extension of its expiration date. The SEC stated that the extension would provide adequate protection to advisory clients while the SEC continues to consider more broadly the regulatory requirements applicable to broker-dealers and investment advisers.

SEC Includes Valuation Guidance in Money Market Fund Rule Release

In the adopting release for the recent money market fund rule amendments, the SEC provided guidance for the valuation of short-term debt securities and thinly-traded holdings that is applicable to all registered investment companies and business development companies. The SEC's guidance focused on two issues: amortized cost valuation and the use of evaluated prices from pricing services. The guidance states that, in order to use amortized cost to value a security (including debt securities with remaining maturities of 60 days or less), a fund must be able to reasonably conclude *each time* it makes a valuation determination that the amortized cost is *approximately the same* as the fair value of the security as determined using market-based factors. Accordingly, the guidance notes that it would not be appropriate to evaluate the use of amortized cost on just a quarterly basis or when preparing financial statements.

The SEC also reminded directors that a fund board "has a non-delegable responsibility to determine whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security." The SEC's guidance includes the following matters for fund boards to consider with respect to the use of evaluated prices from a pricing service to assist in determining fair value:

- the inputs, methods, models and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models and assumptions are affected (if at all) as market conditions change;
- the quality of the evaluated prices provided by the pricing service and the time at which the pricing service determines its evaluated prices as compared to when the fund calculates its net asset value; and
- the appropriateness of using evaluated prices provided by a pricing service as fair values for the fund's portfolio securities where the board does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions.

Litigation and Enforcement Actions

SEC Charges Investment Advisory Firm and Top Officials with Custody Rule Violations

On October 29, 2014, the SEC brought charges against Sands Brothers Asset Management, LLC; Steven Sands and Martin Sands, the firm's co-chairmen; and Christopher Kelly, the firm's chief compliance officer and chief operating officer, for violating Rule 206(4)-2 (the "custody rule") under the Advisers Act by repeatedly failing to distribute audited financial statements to the firm's private fund investors within 120 days of the end of the fiscal year. The SEC's order alleges that Sands Brothers Asset Management willfully violated the custody rule and that Steven Sands, Martin Sands and Christopher Kelly aided and abetted the violation. According to the SEC's order, Sands Brothers Asset Management and Steven Sands and Martin Sands were previously sanctioned by the SEC in 2010 for custody rule violations.

SEC Settles Charges Against Barclays Capital for Compliance Failures After Acquisition of Lehman's Advisory Business

On September 23, 2014, the SEC settled charges against Barclays Capital Inc. for failing to maintain an adequate internal compliance system after it acquired the advisory business of Lehman Brothers in September 2008. According to the SEC's order, Barclays Capital failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and failed to maintain certain required books and records. The SEC found that these deficiencies contributed to various violations of the Advisers Act by Barclays Capital, including executing more than 1,500 principal transactions with clients without making the required written disclosures or obtaining client consent; charging commissions and fees that were inconsistent with its disclosures to clients; and violating the custody rule under the Advisers Act. Barclays Capital agreed to pay a $15 million penalty and retain an independent compliance consultant to settle the charges.

SEC Settles Charges Against Investment Advisory Firm for Undisclosed Principal Transactions and Misleading Performance Advertisements

On September 18, 2014, the SEC settled charges against Strategic Capital Group, LLC and its CEO, N. Gary Price, for engaging in hundreds of principal transactions through its affiliated broker-dealer without informing clients or obtaining their consent and for distributing false and misleading advertisements to investors. According to the SEC's order, Strategic Capital engaged in more than 1,100 principal transactions through its broker-dealer affiliate without making the required disclosures to clients or obtaining consent. The SEC found that Strategic Capital also failed to seek best execution for the transactions it executed through its broker-dealer affiliate, and that Mr. Price signed regulatory filings incorrectly stating that Strategic Capital did not engage in principal transactions. The SEC also found that Strategic Capital distributed false and misleading advertisements to prospective investors, with one advertisement

failing to disclose that the portrayed results were partially based on returns of an index rather than actual, historical returns, and the other advertisement failing to disclose that the results portrayed were gross of fees.

The SEC's order found that Strategic Capital violated the antifraud, principal transactions, advertising, compliance and reporting provisions of the Advisers Act. The SEC's order also found that Mr. Price caused Strategic Capital's violations of the compliance and reporting provisions of the Advisers Act. Strategic Capital agreed to pay nearly $600,000 to settle the SEC's charges and Mr. Price agreed to pay a $50,000 penalty. Strategic Capital also agreed to retain an independent compliance consultant.

SEC Settles Multiple Enforcement Actions for Failure to Timely File Reports of Beneficial Ownership

On September 10, 2014, the SEC settled charges against a number of directors and officers, companies and significant stockholders for failing to timely file reports of beneficial ownership. The SEC used computer algorithms and quantitative data sources to identify delinquent filers of Section 16(a) reports (Forms 3, 4 and 5) and Schedules 13D and 13G. The SEC charged 14 individuals serving as public company directors and/or executive officers, five individual beneficial owners of publicly traded securities, 10 investment firms and seven public companies. Thirty-five out of the 36 persons and entities charged agreed to settle (without admitting fault) and paid penalties ranging from $25,000 to $375,000. While the SEC's actions targeted individuals and companies "with especially high rates of filing deficiencies," the SEC warned that "[o]fficers, directors, major shareholders, and issuers should all take note: inadvertence is no defense to filing violations, and we will vigorously police these sorts of violations through streamlined actions." In the cases of the sanctioned directors and officers, many had dozens of unreported or late-reported transactions spanning time periods, in some cases, of over two years. The SEC emphasized that the ultimate legal responsibility for filing beneficial-ownership reports rests with the individual. Directors and officers were not excused from their violations simply because the company where they serve as officer or director failed to make timely filings on their behalf or because brokers failed to provide timely notices of the insiders' market purchases or sales. With respect to companies, while the SEC encourages companies to assist their insiders with their Section 16(a) reporting obligations, companies that do so may become liable for causing violations by their insiders where the companies act negligently in the performance of those tasks. In addition, companies may become liable for inaccurate proxy statement disclosure if statements about insiders' Section 16(a) report filings are incorrect.

SEC Charges Investment Advisory Firm with Failure to Disclose Conflict of Interest to Clients

On September 2, 2014, the SEC brought charges against The Robare Group Ltd. and its owners Mark Robare and Jack Jones, Jr. for recommending that clients invest in particular funds without disclosing that the firm was receiving compensation from the broker offering the funds. According to the SEC's order, in 2004, Robare Group entered into an agreement with a broker that provided for the broker to compensate Robare Group for investing client assets in certain funds on the broker's platform; however, the SEC alleges that Robare Group did not disclose this compensation arrangement to clients through its Form ADV or otherwise until 2011. The SEC further alleges that, when Robare Group did revise its Form ADV in December 2011 to disclose the compensation arrangement, the disclosures were inadequate. The SEC's order states that Messrs. Robare and Jones, Jr. approved Robare Group's Form ADV filings knowing that they failed to disclose or failed to adequately disclose the compensation arrangement and the related conflict of interest.

The SEC's order alleges that Robare Group and Mr. Robare willfully violated Sections 206(1) and 206(2) of the Advisers Act, and that Mr. Jones, Jr. aided and abetted these violations. The SEC further alleges that the Robare Group and Messrs. Robare and Jones, Jr. each willfully violated Section 207 of the Advisers Act.

District Court Grants Summary Judgment and Dismisses Case Regarding Insider Trading Prohibitions and Mutual Fund Redemptions

On August 29, 2014, the U.S. District Court for the Eastern District of Wisconsin granted Jilaine H. Bauer's motion for summary judgment in *Securities and Exchange Commission v. Bauer* and dismissed the SEC's case, determining that

an insider trading claim brought under a “misappropriation theory” was not properly presented to the court and that a “misappropriation theory” did not properly apply to the conduct of Ms. Bauer, who at all relevant times was a corporate insider.

In the fall of 2000, Ms. Bauer served as general counsel, chief compliance officer and chairperson of the pricing committee for Heartland Advisors, Inc. (HAI), and as vice president and secretary of Heartland Group, Inc. (HGI), an open-end fund. 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. Ms. Bauer 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 Ms. Bauer with insider trading, and on May 25, 2011, the district court 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.” In order to expedite the entry of judgment against Ms. Bauer on the insider trading claim, the SEC filed an unopposed voluntary motion to dismiss with prejudice all claims against Ms. Bauer other than the counts of insider trading discussed in the May 25, 2011 opinion. The district court granted the SEC’s voluntary motion to dismiss on September 20, 2011.

On appeal to the U.S. Court of Appeals for the Seventh Circuit, Ms. Bauer 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.” The SEC abandoned the “classical theory” on appeal, instead arguing that Ms. Bauer 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.

On July 22, 2013, the Seventh Circuit reversed the district court’s ruling 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 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 Ms. Bauer’s redemptions and to resolve questions of fact related to the materiality of Ms. Bauer’s non-public information and whether Ms. Bauer acted with scienter.

On remand, the district court granted summary judgment to Ms. Bauer and dismissed the remainder of the SEC’s insider trading case. In granting summary judgment, the district court noted that the SEC never properly raised the “misappropriation theory” before the court, and that, as a general matter, any theory not raised before the district court is deemed waived or forfeited. In addition, the district court noted that the “misappropriation theory” was different from the insider trading claim discussed in the court’s May 25, 2011 opinion and, as a result, any claim based on such theory would have been dismissed with prejudice pursuant to the SEC’s voluntary motion to dismiss granted on September 20, 2011. Moreover, the district court refused to extend the “misappropriation theory” of insider trading to Ms. Bauer given her status as an officer of the investment adviser to the Funds at all relevant times. The district court could find no precedent supporting the extension of the “misappropriation theory,” which has generally been interpreted to apply only to conduct by corporate outsiders, to a corporate insider and stated that the SEC did not sufficiently explain “how an officer at a mutual fund investment adviser can be fairly considered a corporate ‘outsider’ given the investment adviser’s deeply entwined role as sponsor and external manager of the fund.”

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