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SEC, SRO, AND PRIVATE LITIGATION DEVELOPMENTS AFFECTING MUTUAL FUNDS, HEDGE FUNDS, AND INVESTMENT ADVISORS, 2010-2011

Mutual funds, hedge funds, and investment advisors have remained a prominent focus of the SEC's Enforcement program in the past year. Many of the headlines have been taken up with insider trading matters involving hedge funds, but the industry should not lose focus on the other enforcement priorities of the SEC (and, to a certain extent, FINRA as well). The SEC's Division of Enforcement now has a fully operational Asset Management Unit that is bringing cases involving asset valuations, disclosures, trading violations, and related party transactions. We can expect further enforcement activity as a result of the SEC's recently-approved whistleblower rules.

This outline summarizes SEC and SRO enforcement cases of interest in the past year, followed by a survey of recent developments in private litigation.

I. SEC and SRO Enforcement Matters

A. Insider Trading and Expert Networks

1. The well-publicized conviction of Raj Rajaratnam in the *Galleon* case and the guilty pleas of many others involved in that case have put to rest any notion that insider trading – even criminal insider

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trading – is limited to defendants who line their own pockets as opposed to capitalizing on inside information for the benefit of funds that they manage.

a. The *Galleon* cases include one of the very few administrative insider trading cases that the Commission has ever brought. *In the Matter of Rajat K. Gupta*, Securities Exchange Act Rel. No. 63995 (March 1, 2011) (in litigation)

2. The recent crop of insider cases has also placed a harsh spotlight on so-called "expert networks." At the beginning of this year, for example, the SEC filed a civil complaint against six individuals, already indicted, for alleged insider trading at the expert networking firm Primary Global Research LLC. Two of the individuals were employees of the firm; the other four were technology company employees who acted as consultants for Primary Global. The charges involve passing along confidential information regarding quarterly earnings and performance data to hedge funds and other client who profited by nearly $6 million. *SEC v. Mark Anthony Longoria, et al.*, Lit. Rel. No. 21836 (Feb. 3, 2011).[2]

[2]*See also SEC v. Dr. Yves M. Benhamou*, Lit. Rel. No. 21721 (Nov. 2, 2010) (insider trading case brought against a doctor who allegedly provided a hedge fund portfolio manager with material, non-public information regarding a clinical trial by public company Human Genome Science, Inc. in advance of a negative press release regarding the trials).

II. Other SEC and SRO Enforcement Matters Involving Mutual Funds, Hedge Funds, and Investment Advisors

A. Valuation and Disclosures

1. *In the Matter of Daniel M. Hughes*, Securities Exchange Act Rel. No. 64493 (May 13, 2011) (false oral statements to client and falsified brokerage statements to conceal trading losses)

2. *SEC v. Algorithmic Trading Advisors, LLC, et al.*, Lit. Rel. No. 21840 (Feb. 7, 2011); see also Investment Advisers Act Rel. No. 3163 (Feb. 17, 2011) (provision of false performance and AUM information to Morningstar, BarclayHedge, and Hedge Fund Research, Inc.)

3. *In the Matter of Alpine Woods Capital Investors, LLC, et al.,* Investment Advisers Act Rel. No. 3154 (Feb. 7, 2011) (misallocation of IPOs and failure to disclose material impact that misallocation had on returns of favored funds)

4. *In the Matter of AXA Rosenberg Group LLC, et al.,* Investment Advisers Act Rel. No. 3149, Investment Company Act Rel. No. 29574 (Feb. 3, 2011) (misinformation to investors regarding an error generated by proprietary investment model)

5. *In the Matter of Michael R. Pelosi*, Investment Advisers Act Rel. No. 3141 (Jan. 14, 2011) (litigated matter involving alleged misrepresentations of performance; spoliation of documents)

6. *In the Matter of Charles Schwab Investment Management,* Investment Advisers Act Rel. No. 3136, Investment Company Act Rel. No. 29552 (Jan. 11, 2011) (misstatements and omissions regarding nature of investments and deviation from Fund's concentration policy)

7. *SEC v. Southridge Capital Mgmt. LLC, et al.*, Lit. Rel. No. 21709 (Oct. 25, 2010) (overvaluation of hedge funds' largest position; misusing liquid assets in certain funds to pay millions of dollars in expenses of other, illiquid funds; failing to report that misappropriation to clients and replacing the misappropriated assets with illiquid securities)

8. *SEC v. Paul T. Mannion, Jr., et al.*, Lit. Rel. No. 21699 (Oct. 19, 2010) (overvaluing funds in "side pocket" and misappropriation of fund assets)

9. Still being litigated is *In the Matter of Morgan Asset Management, Inc., Morgan Keegan & Company, Inc., et al.,* Investment Advisers Act Rel. No. 3009, Investment Company Act Rel. No. 29203 (Apr. 7, 2010) (alleged inflation of daily NAV of mutual funds through manipulation of quotations, submission of inaccurate prices to Valuation Committee, and failure to adhere to valuation policies and procedures)

B. Related Party Violations

1. *In the Matter of Wunderlich Securities, Inc.,* Securities Exchange Act Rel. No. 64558 (May 27, 2011) (undisclosed principal transactions and excessive fees)

2. *In the Matter of Melhado, Flynn & Assoc., Inc.*, Securities Exchange Act Rel. No. 64449 (May 11, 2011) (cherry-picking in allocations to favor an affiliated hedge fund)

3 *In the Matter of JSK Associates, Inc.*, et al., Investment Advisers Act Rel. No. 3175 (March 14, 2011) (failure to disclose financial benefits that an affiliated broker-dealer gained from advisory clients' accounts; undisclosed principal trading)

4 *SEC v. Illaramendi,* Lit. Rel. No. 21828 (Jan. 14, 2011) (litigated matter alleging that advisor caused fund to make undisclosed loans to affiliates that then used the funds to invest in private equity) (see also Lit Rel. Nos. 21875, 21970)

5 *In the Matter of American Pegasus LDG, LLC*, et al., Securities Exchange Act Rel. No. 63585 (Dec. 21, 2010) (company controlled by investment advisors loans money to advisee fund; advisor collects management fees on the value of the assets acquired through the loans)

6 *In the Matter of Neal R. Greenberg,* Securities Exchange Act Rel. No. 62855 (Sept. 7, 2010); *see also* Securities Exchange Act Rel. No. 63932 (Feb. 18, 2011) (officer of one registered investment

advisor recommends investments in funds that he also managed, overstates the diversification and liquidity of those funds, and charges management fees on investments in those funds even though the PPM said that no additional fees would be charged if investor capital went into affiliated funds)

C. Misconduct in Connection with Required Filings and Exams

1 *In the Matter of Aletheia Research and Management, Inc.*, et al., Securities Exchange Act Rel. No. 64442 (May 9, 2011) (failure to disclose requested information regarding SEC exams in proposals to clients and potential clients; failure to hold surprise examinations; failure to make and/or keep copies of employees' Code of Ethics acknowledgments even after receiving deficiency letters on that point)

2. *In the Matter of Diane M. Keefe*, Investment Advisers Act Rel. No. 3135, Investment Company Act Rel. No. 29551 (Jan. 10, 2011) (creation of notes of meetings of a non-existent Investment Committee in preparation for OCIE exam)

3 *In the Matter of FreedomTree Mutual Funds and Asset Management LLC*, Investment Advisers Act Rel. No. 3095 (Sept. 30, 2010) (misstatements on Form ADV regarding investment advisor's AUM and clients; other misstatements on advisor's Website; failure to respond to OCIE meeting request, document requests, and deficiency letters)

E. Trading Violations

1. *In the Matter of Donald L. Koch and Koch Asset Management LLC*, Securities Exchange Act Rel. No. 64337 (April 25, 2011) (litigated matter involving alleged marking-the-close violations)

2. *In the Matter of Horseman Capital Management, L.P.*, Securities Exchange Act Rel. No. 63757 (Jan. 24, 2011) (participating in public offering after having shorted the stock within the restricted period specified by Rule 105)

3. *In the Matter of Fontana Capital, LLC*, et al., Securities Exchange Act Rel. No. 63672 (Jan. 7, 2011) (litigated matter alleging Rule 105 violations)

F. Procedures to Prevent the Misuse of Material, Non-public Information

1. *In the Matter of The Buckingham Research Group, Inc., et al.*, Securities Exchange Act Rel. No. 63323 (Nov. 17, 2010) (settled enforcement action brought against broker-dealer/institutional equity research firm, its investment advisor subsidiary, and the CCO of both entities for failure to have adequate policies and procedures in place to protect material non-public information, and for failure to enforce the policies that the firms did have in place.

G. Auction Rate Securities

1. In an enforcement arena dominated by actions brought against wirehouses and other large broker-dealers, FINRA levied a $3 million fine against Nuveen Investments, LLC, the distributor for

the Nuveen Funds, for creating misleading marketing materials for auction rate preferred securities issued by the Funds that FINRA claimed failed to adequately disclose the liquidity risks for those securities. *FINRA Letter of Acceptance, Waiver and Consent Re: Nuveen Investments, LLC*, released on May 23, 2011).

II. Private Litigation

A. Auction Rate Securities

1. In a twist on the numerous regulatory cases (including the *Nuveen* AWC above) brought to vindicate the interests of auction rate security holders, the past year has seen a number of civil actions threatened and/or brought on behalf of common shareholders of closed-end mutual funds, claiming that the funds' redemptions of ARPS holders harmed the funds or the common shareholders. These cases include derivative actions filed in state court against six fund complexes, one of which was dismissed voluntarily, and purported class actions brought against three fund complexes, one of which has been dismissed and is currently on appeal to the Court of Appeals for the Seventh Circuit. *Brown v. Calamos*, 2011 WL 893028 (N.D. Ill. Mar. 14, 2011), *appeal pending*, No. 11-1785 (7th Cir., filed April 5, 2011).

B. Section 36(b) Litigation

1. Last year's decision by the Supreme Court in *Jones v. Harris Associates, L.P.*, 130 S. Ct. 1418 (2010) lessened uncertainty in

this area by reaffirming the *Gartenberg* standards for weighing excessive fee claims.

2. Section 36(b) cases in the past twelve months have, unsurprisingly, been devoted to implementing *Jones* (e.g., *Gallus v. American Express Fin. Corp.*, 2010 WL 5137419 (D. Minn. Dec. 10, 2010) (ruling for the defendants based on *Jones*), *appeal pending*, No. 11-1091 (8th Cir. filed Jan. 13, 2011); *Bennett v. Fidelity Management & Research Co.*, 2011 WL 98837 (D. Mass. Jan. 10, 2011) (ordering specific briefing on the *Jones*/*Gartenberg* factors)), or exploring 36(b) issues not decided by *Jones* (see, e.g., *Curran v. Principal Management Corp., LLC*, 2011 WL 223872 (S.D. Iowa Jan. 24, 2011) (ruling that a shareholder in a fund of funds lacks standing to pursue a Section 36(b) claim on behalf of the underlying funds in which the plaintiff holds no shares).

C. Plaintiffs' efforts to find new causes of action under the Investment Company Act have not met with much success against defendants' motions to dismiss.

1. In *Smith v. Franklin/Templeton Distributors, Inc.*, 2010 WL 4286326 (N.D. Cal. Oct. 22, 2010), the court dismissed a complaint that sought to void 12b-1 fees under Section 47(b) (rendering unenforceable contracts that involve a violation of the Act or the regulations thereunder) because the plaintiff had failed to show a violation of Section 36(a) or Rule 38a-1, to which the

plaintiff had pointed after having been rebuffed in his effort to rely on Section 202 of the Investment Advisers Act as a predicate violation.

2. In *Northstar Financial Adv., Inc. v. Schwab Investments,* 615 F.3d 1106 (9th Cir. 2010), the court reversed a district court that had recognized an implied private right of action under Section 13(a), concluding that no such action exists.

3. And in *In re Regions Morgan Keegan Securities, Derivative & ERISA Litigation.*, 2010 WL 3925265 at *13-14 (W.D. Tenn. Sept. 30, 2010), the district court refused to permit implied private rights of action under Sections 13, 22, 30, or 34(b).

D. Investment advisors facing claims under the Securities Act have had a more mixed record of success on motions to dismiss.

1. Recent examples of cases in which Securities Act claims have been permitted to go forward into the discovery phase are *Zametkin v. Fidelity Management & Research Co.*, No. 1:08-CV-10960-MLW (D. Mass. Nov. 15, 2010) and *In re Regions Morgan Keegan Securities, Derivative & ERISA Litigation*, *supra*.

2. However, in a development that could change considerably the entire complexion of Securities Act litigation involving mutual fund shares, the court in *Yu v. State Street Corp.*, 2011 WL 1206070 (S.D.N.Y. March 31, 2011) dismissed shareholder claims on the ground that plaintiff could never show loss causation

because mutual fund shares are set each day on the basis of the fund's NAV, which does not respond to the fund's disclosures.

E. Rule 10b-5 liability of investment advisors for false statements in mutual fund disclosure documents has been effectively extinguished by *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525 (U.S. June 13, 2011), in which the Supreme Court held that only the mutual fund company in whose name a disclosure is made can be held liable in a private action under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.