GODFREY & KAHN S.C.

Investment Management Focus

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Godfrey & Kahn Investment Management Team Members Responsible for this Update

Christopher M. Cahlamer
414.287.9338
ccahlamer@gklaw.com

Leah N. Cry
608.284.2232
lcry@gklaw.com

Julie A. D'Angelo
608.284.2622
jdangelo@gklaw.com

Thomas M. Davison
414.287.9369
tdavison@gklaw.com

Carol A. Gehl
414.287.9255
cgehl@gklaw.com

Susan M. Hoaglund
262.951.7136
shoaglund@gklaw.com

Scott Zimmerman
414.287.9367
szimmerman@gklaw.com

Legal and Regulatory Update

Latest Developments

The State of the SEC

Only two commissioners will remain when current SEC Chair Mary Jo White steps down as head of the SEC this month: Democrat Kara Stein and Republican Michael Piwowar. Of the two remaining commissioners, Mr. Piwowar will likely be named as acting chairman in advance of the expected confirmation of President Trump's nominee: New York attorney Jay Clayton. Mr. Clayton is a partner at Sullivan & Cromwell LLP in New York where his practice focuses primarily on mergers and acquisitions transactions, capital markets offerings, and regulatory and enforcement proceedings.

Although the SEC ordinarily has five commissioners, Commissioners Stein and Piwowar can be expected to continue day-to-day SEC operations, including the commencement of enforcement actions, before additional commissioners are appointed and confirmed. Only the SEC acting with a quorum of its commissioners present may authorize the institution of an administrative proceeding to impose remedial sanctions. Exchange Act Release No. 35548 clarifies that even "one commissioner would constitute a quorum if no other commissioners [were] in office."

Sources: 15 U.S.C. § 78d(a); 17 CFR 200.41; Exchange Act Release No. 35548 (March 30, 1995); President-Elect Donald J. Trump Nominates Jay Clayton Chairman of the SEC, GreatAgain (January 4, 2016), available at https://greatagain.gov/tagged/releases.

SEC Announces 2017 Exam Priorities

On January 12, 2017, the SEC's Office of Compliance Inspections and Examinations (OCIE) published its 2017 examination priorities for investment advisers, investment companies, and broker-dealers. The priorities introduce new areas of focus, including electronic investment advice, money market funds, and financial exploitation of senior investors, and reflect a continuing focus on some of last year's examination priorities, including exchange-traded funds and cybersecurity. OCIE Director Marc Wyatt remarked that the 2017 examination priorities "identify where [the SEC] see[s] risk to investors so that registrants can evaluate their own compliance programs . . . and make necessary changes and enhancements."

This year's examination priorities are informed by three themes: protecting retail investors generally, focusing on senior investors and retirement investors, and assessing market-wide risks. Of the complete list of examination priorities, which is available on the SEC's website, we have highlighted the most relevant examination priorities below.

Protecting Retail Investors
OCIE will continue to focus on protecting retail investors in 2017, with an emphasis on assessing potential risks to investors arising out of the widening array of information, advice, products, and services offered by the financial services industry.

<u>Electronic Investment Advice.</u> OCIE will examine the compliance programs, marketing, formulation of investment recommendations, data protection, and disclosures of advisers and broker-dealers that offer such services. This will include both "robo-advisers," which primarily interact with clients online, and firms that utilize automation as only a component of their services.

<u>Wrap Fee Programs.</u> OCIE will check to ensure that advisers and broker-dealers with wrap fee programs, which charge investors a single bundled fee for advisory and brokerage services, are acting in a manner consistent with their fiduciary duty and meeting their contractual obligations to clients. Particular attention will be given to disclosures, the handling of potential conflicts of interest, and brokerage practices, including best execution and trading away.

<u>Exchange-Traded Funds.</u> OCIE will continue to examine ETFs, with particular attention given to ETF compliance with applicable exemptive relief granted under federal securities laws, unit creation, redemption processes, and sales practices and disclosures involving the suitability of recommendations to purchase ETFs with niche strategies.

<u>Multi-Branch Advisers.</u> OCIE is focusing on these entities in light of its view that a branch office model can make it difficult for advisers to design and implement a compliance program or provide sufficient oversight of their advisory services.

<u>Share Class Selection.</u> OCIE will continue to review factors that may affect recommendations for clients to invest in particular share classes of mutual funds, including, for example, conflicts of interest that arise when investment advisory personnel are also representatives of broker-dealers and, therefore, may be inclined to recommend share classes that have higher sales loads or distribution fees.

Focusing on Senior Investors and Retirement Investments
As the aging U.S. population becomes more dependent on their own investments for retirement income, OCIE has resolved to dedicate increased attention to the following:

<u>ReTIRE.</u> OCIE will continue its multi-year examination initiative focused on the services investment advisers and broker-dealers offer to investors with retirement accounts, with particular attention given to, among other things, registrants' recommendations and sales of variable insurance products, and sales and management of target date funds.

<u>Public Pension Advisers.</u> OCIE will examine investment advisers to state, municipality and other government pension plans to assess how they are managing conflicts of interest and fulfilling their fiduciary duties.

<u>Senior Investors.</u> OCIE will evaluate how firms manage their interactions with senior investors, including their ability to identify financial exploitation of seniors. Examinations will focus on firms' supervisory programs and controls relating to products and services directed at senior investors.

Assessing Market-Wide Risks
OCIE will continue to examine structural risks and trends that may involve multiple firms or entire industries as part of its mission to maintain fair, orderly, and efficient markets, including the following:

Money Market Funds. OCIE will examine money market funds for compliance with rule amendments, adopted in 2014 and effective as of October 2016. These examinations will include assessments of boards' oversight of compliance with the new amendments, compliance policies relating to stress testing, and periodic reporting requirements.

Cybersecurity. OCIE will continue its initiative to examine and test the implementation of cybersecurity compliance procedures and controls.

Anti-Money Laundering (AML). OCIE will continue to examine broker-dealers to assess compliance with suspicious activity report requirements, how broker-dealers are monitoring for suspicious activity at the firm, and whether AML programs are tailored to the specific risks that the firm faces.

Other Initiatives
In addition to the above, the staff also plans to allocate examination resources to the following priorities:

Municipal Advisers. OCIE will continue to evaluate municipal advisers' compliance with SEC and Municipal Securities Rulemaking Board rules.

Private Fund Advisers. OCIE will continue to examine private fund advisers with a focus on their treatment of conflicts of interest, the disclosure of such conflicts, and the appearance of conflicts.

Sources: Examination Priorities for 2017, Office of Compliance Inspections and Examinations (January 12, 2017), available at https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf; SEC Announces 2017 Examination Priorities, Press Release No. 2017-7 (January 12, 2017), available at https://www.sec.gov/news/pressrelease/2017-7.html.

SEC Guidance in Connection with DOL Fiduciary Rule

SEC Issues Interpretive Letter on Broker Commissions Related to Sales of Mutual Fund Shares

On January 11, 2017, the SEC's Division of Investment Management (IM Division) issued an interpretive letter indicating that the restrictions of Section 22(d) of the Investment Company Act do not apply when a broker acts as an agent for its customers and charges commissions for effecting transactions in mutual fund shares without a front-end sales load, deferred sales charge or other asset-based fee (referred to as "clean shares").

Capital Research and Management Company and Capital Group Companies, Inc., on behalf of the American Funds, requested SEC guidance to address issues that have arisen for the mutual fund industry under the DOL fiduciary rule. As Capital Group explains it:

> A principal way that the DOL rule seeks to address conflicts is by eliminating financial incentives that could cause a broker to recommend one investment offering over another. In this regard, the DOL rule shows a preference for arrangements in which the financial adviser receives payments only from the investor and not from third parties. … We understand that certain broker-dealer firms are contemplating a brokerage platform on which they will apply their own commissions to fund transactions. Other firms are taking a more cautious approach, in part due to uncertainty around the applicability of Section 22(d).

Section 22(d) of the Investment Company Act, often referred to as the retail price maintenance rule, prohibits a mutual fund, the fund's principal underwriter, and dealers from selling the fund's shares at a price other than the current public offering price described in the fund's prospectus. The Capital Group letter explains that, although Section 22(d) does not apply to brokers, many firms are unsure whether charging a commission for effecting transactions in clean shares could cause them to be treated as dealers under Section 22(d).

The SEC interpretive letter confirms that the restrictions of Section 22(d) do not apply to a broker when the broker acts as agent on behalf of its customers and charges commissions for effecting transactions in clean shares. In taking this position, the staff requires the following:

- The broker will represent in its selling agreement with the fund's underwriter that the broker is acting solely on an agency basis for the sale of clean shares;
- The clean shares sold by the broker will not include any form of distribution-related payment to the broker (the SEC staff notes that its letter does not address the effect under Section 22(d) of a broker receiving revenue sharing payments from the fund's adviser);
- The fund's prospectus will disclose that an investor transacting in clean shares may be required to pay a commission to a broker and, if applicable, that shares of the fund are available in other share classes that have different fees and expenses;
- The broker may determine the nature and amount of the commissions and the times at which they would be collected subject to the broker's obligations under applicable FINRA and DOL rules; and
- Purchases and redemptions of clean shares will be made at the net asset value (NAV) established by the fund (before imposition of a commission by the broker).

The SEC staff also stated that Section 22(d) does not prohibit a principal underwriter of clean shares from entering into a selling agreement with a broker under these circumstances. Finally, the staff position does not depend on whether the broker sells clean shares to investors in retirement accounts or nonretirement accounts.

Sources: Capital Group Interpretive Letter under Section 22(d) of the Investment Company Act of 1940 – Fund Shares Distribution (pub. avail. January 11, 2017), available at https://www.sec.gov/divisions/investment/noaction/2017/capital-group-011117-22d.htm; SEC Division of Investment Management Issues Interpretive Letter under Section 22(d) of the Investment Company Act of 1940, Investment Company Institute Memorandum 30518 (January 12, 2017).

SEC Publishes Guidance on Mutual Fund Fee Structures

The IM Division issued a Guidance Update, "Mutual Fund Fee Structures," in connection with the DOL fiduciary rule. The IM Division noted that mutual funds have been considering a variety of issues related to the DOL's rule implementation, including:

- Variations in Sales Loads. Funds are contemplating certain changes to fund fee structures that would, in certain instances, level the compensation provided to a financial intermediary.
- New Share Classes. Funds are considering streamlined sales load structures to simplify costs for investors and to help address operational and compliance challenges that can exist for intermediaries that sell shares of multiple funds.

Variations in Sales Loads

The SEC recognizes that funds are considering new variations to sales loads that would apply uniformly to investors that purchase shares through a single intermediary (or the same category of multiple intermediaries).

Rule 22d-1 under the Investment Company Act and Item 12(a)(2) of Form N-1A require that each variation in sales load be applied uniformly to particular "classes" of investors or transactions and disclosed in the prospectus with specificity. The Guidance confirms that investors who purchase shares through a designated intermediary would be a class, and, therefore, the disclosure should specifically identify each intermediary whose clients will receive a sales load variation. This information must be presented in a clear, concise and understandable manner, and should include tables, schedules and charts where doing so would facilitate understanding. In addition, the narrative explanation to the fee table must alert investors to the existence of sales load discounts or waivers and provide a cross-reference to the section and page of the prospectus and statement of additional information that describes these arrangements.

In recognition that this approach may lead to lengthy disclosures that may be difficult for investors to understand, the Guidance permits sales load variation disclosure for multiple intermediaries to be included in an appendix to the statutory prospectus. In order to use an appendix:

- The section of the prospectus that includes disclosure that is required by Item 12 of Form N-1A should include a prominent statement to the effect that different intermediaries may impose different sales loads and that these variations are described in an appendix to the prospectus (the specific appendix should be named).
- The narrative explanation to the fee table must cross-reference the appendix.
- The appendix must specifically identify the name of each intermediary as required by Item 12(a)(2) of Form N-1A. It also should include sufficient information to allow an investor to determine which scheduled variation applies to its purchase, which may depend on the type of account held at the intermediary.

The Guidance also permits funds to use a standalone appendix, provided that the fund:

- Incorporates the appendix into the prospectus by reference and files the appendix;
- Includes a legend on the front cover page of the appendix explaining that the information disclosed in the appendix is part of, and incorporated in, the prospectus;
- Includes a statement on the outside back cover page of the prospectus that information about the different sales load variations is provided in a separate document that is incorporated by reference in the prospectus;
- Delivers the appendix with the prospectus; and
- If the fund uses a summary prospectus, posts the appendix on its website consistent with Rule 498(e) under the Securities Act.

To add disclosure about sales load variations, a fund must file an amendment to its registration statement under Rule 485(a) of the Securities Act. The Guidance encourages funds to seek selective review of the amended filing if the fund is only making changes to certain disclosures, such as adding sales load variations. If sales load variations will be substantially identical for multiple funds within a fund complex, the Guidance suggests funds should consider requesting relief under Rule 485(b)(1)(vii) (referred to as "template filing relief").

New Share Classes

The SEC also understands that funds are considering offering new share classes that differ with respect to sales loads, transaction charges, and certain ongoing expenses. Adding a new share class to an existing fund requires a filing under Rule 485(a). The Guidance states that if only certain disclosures about the fund are changing, such as describing a new share class, funds should seek selective review of the filing. Also, if the information is substantially identical across funds within the same fund complex, funds should consider whether it is appropriate to request template filing relief.

Selective Review
The Guidance encourages funds requesting selective review of Rule 485(a) filings to note this in the cover letter accompanying the filing. Any such request should include the following:

- A statement as to whether the disclosure in the filing has been reviewed by the SEC staff in another context;
- A statement identifying prior filings that the fund considers similar to, or intends as precedent for, the current filing;
- Summary of the material changes; and
- Specific areas that the fund believes warrant particular attention.

Template Filing Relief
Where a fund complex makes substantially identical changes to multiple funds, template filing relief may be appropriate. Funds that wish to request template filing relief should do so in correspondence filed on the EDGAR system under the central index key (CIK) of the template filing. The request should state: (i) the reason for making the post-effective amendment; (ii) the identity of the template filing; and (iii) the identity of the registration statements that intend to rely on the relief. In addition, the correspondence should represent that:

- The disclosure changes in the template filing are substantially identical to disclosure changes that will be made in replicate filings;
- The replicate filings will incorporate changes made to the disclosure included in the template filing to resolve any staff comments thereon; and
- The replicate filings will not include any other changes that would otherwise render them ineligible for filing under Rule 485(b).

Furthermore, subsequent filings relying on template filing relief should include a cover letter or explanatory note in the filing explaining that it is relying on template filing relief.

Source: Mutual Fund Fee Structures, SEC Division of Investment Management, Guidance Release No. 2016-06 (December 2016), available at https://www.sec.gov/investment/im-guidance-2016-06.pdf.

SEC Guidance on Whistleblowers and Recent Enforcement Actions

OCIE Issues Risk Alert Regarding Whistleblower Rule Compliance
On October 24, 2016, OCIE issued a risk alert regarding its ongoing examination of registrants' compliance with key whistleblower provisions of the Exchange Act. More specifically, OCIE is reviewing certain documents used by registered investment advisers and registered broker-dealers in order to determine whether provisions contained therein raise concerns under Rule 21F-17 of the Exchange Act.

Rule 21F-17 stipulates that "no person may take any action to impede an individual from communicating directly with the [SEC] staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement … with respect to such communications." It was adopted by the SEC to implement Section 21F of the Exchange Act titled "Securities Whistleblower Incentives and Protection," which was added to the Exchange Act by the Dodd-Frank Act. The congressional purpose underlying Section 21F is "to encourage whistleblowers to report possible violations of the securities laws by providing financial incentives, prohibiting employment-related retaliation, and providing various confidentiality guarantees."

OCIE staff is analyzing compliance manuals, codes of ethics, employment agreements, severance agreements, and other documents to identify provisions that the SEC has found to violate Rule 21F-17, including provisions that do any of the following:

- purport to limit the type of information that an employee may convey to the SEC or other authorities;
- require departing employees to waive their rights to any individual monetary recovery in connection with reporting information to the government;
- require an employee to represent that he or she has not assisted in any investigation involving the registrant; or
- prohibit any and all disclosures of confidential information, without any exception for voluntary communications with the SEC concerning possible securities laws violations.

When examining registrant compliance with Rule 21F-17, the staff is citing deficiencies and making referrals to the Division of Enforcement when appropriate. In its enforcement actions, the SEC has required registrants to revise documents to make it clear that nothing contained in them prohibits voluntary communication with the SEC or deprives signatories from recovering a whistleblower award. Registrants also have been required to contact current and former employees who signed restrictive documents to inform them that the registrant does not prohibit them from contacting the SEC or seeking whistleblower awards.

Whistleblower Enforcement Actions
In our *July 2015 Update*, we told you about the SEC's enforcement action against KBR, Inc. for using improperly restrictive language in confidentiality statements, which stated that employees could be subject to discipline or termination for disclosing the content of internal investigations to outside authorities without prior approval from the company's legal department. Since the subject matter of some of the interviews involved potential securities law violations, the SEC found the presence of restrictive language in KBR's employee confidentiality statements to directly undermine the purpose of Rule 21F-17.

Although the SEC did not find instances in which KBR actually prevented its employees from disclosing information to the SEC, the Commission nevertheless deemed the statements improper because they *could* have precluded KBR's employees from reporting their concerns. Without admitting or denying the findings, KBR agreed to pay a $130,000 fine to settle the charges. Additionally, KBR voluntarily revised its confidentiality statement to clarify that its employees are not required to obtain approval from the company's legal department before reporting possible violations of federal law to any governmental agency.

The SEC's commitment to whistleblower protections is also evidenced by two August 2016 enforcement actions. *In the Matter of Health Net, Inc.* involved Health Net's use of severance agreements that included a "Waiver and Release of Claims" provision requiring departing employees to waive various potential claims against the company as a condition to receiving monetary severance payments and other consideration. Although the severance agreements did not preclude departing employees from participating in federal agency investigations, it prohibited them from filing an application for, or accepting, a whistleblower award from the SEC. Specifically, the Waiver and Release of Claims expressly required an employee to waive the following:

- "the right to file an application for award for original information submitted pursuant to Section 21F of the Securities Exchange Act of 1934;"
- "any right to bring a lawsuit against the company;" and
- "any right to any individual monetary recovery in any such proceeding or lawsuit or in any proceeding

brought based on any communication by Employee to any federal, state, or local government agency or department."

Without admitting or denying the SEC's finding that Health Net violated Rule 21F-17, Health Net agreed to pay a $340,000 civil money penalty and inform employees who signed a Waiver and Release of Claims that they are not prohibited from communicating with the SEC or seeking a whistleblower reward.

In the Matter of BlueLinx Holdings Inc. involved BlueLinx's use of several forms of severance agreements that prohibited employees from sharing confidential information, except when compelled to do so by law or legal process; required employees to provide written notice to or obtain consent from the company prior to divulging confidential information pursuant to legal process; and required employees to waive their right to any monetary recovery related to any governmental agency investigation. For example, the severance agreements required a signing employee to agree that the employee:

- "has not and in the future will not use or disclose to any third party Confidential Information, unless compelled by law and after notice to BlueLinx;"
- "[will] hold in a fiduciary capacity for the benefit of the Company all Confidential Information …[and, for] a period of two years following [the employee's] Termination Date, [the employee] shall not, without the prior written consent of the Company or as may otherwise be required by law or legal process, communicate or divulge Confidential Information;"
- "in the event disclosure [of Confidential Information] is required by law, [employee] shall provide the Company's Legal Department with prompt written notice of such requirement in time to permit the Company to seek an appropriate protective order or other similar protection prior to any such disclosure by [employee];" and
- "is waiving the right to any monetary recovery in connection with any such complaint or charge that Employee may file with an administrative agency, [such as the SEC]."

Without admitting or denying the SEC's finding that BlueLinx violated Rule 21F-17, BlueLinx agreed to pay a $265,000 civil money penalty, revise its form severance agreement, and inform employees who signed severance agreements that they are not prohibited from communicating with the SEC or seeking a whistleblower reward.

Sources: National Exam Program Risk Alert, OCIE (October 24, 2016), available at https://www.sec.gov/ocie/announcement/ocie-2016-risk-alert-examining-whistleblower-rule-compliance.pdf; In the Matter of Health Net, Inc., Release No. 78590 (August 16, 2016), available at https://www.sec.gov/litigation/admin/2016/34-78590.pdf; In the Matter of BlueLinx Holdings, Inc., Release No. 78528 (August 10, 2016), available at https://www.sec.gov/litigation/admin/2016/34-78528.pdf.

Litigation and SEC Enforcement Actions

Court Applies Fiduciary Exception to Communications between Independent Trustees and Counsel

In November 2016, the United States District Court in the Western District of Washington issued an order in a Section 36(b) excessive fee case, *Kenny v. PIMCO Investments*. The court ruled that the independent trustees of the PIMCO Total Return Fund, a series of a Massachusetts business trust, must produce documents containing sensitive information that they had previously redacted or withheld from the plaintiff under the attorney-client privilege. The court determined that the communications between the trustees and their counsel were not entitled to the attorney-client privilege because a "fiduciary exception" applied.

The plaintiff in the case alleged that PIMCO Investments (PIMCO), the investment adviser to the fund, had breached its fiduciary duty to shareholders of the fund by charging excessive fees, including management, distribution, administrative and servicing charges. The plaintiff also argued that, as the fund grew substantially in size, economies of scale were not passed on to shareholders and that the management structure and high compensation of the trustees led to a lack of board independence and conscientiousness.

In response to the plaintiff's document subpoena, counsel to the independent trustees redacted and withheld over 200 documents on the basis of the attorney-client privilege, arguing that the documents contained communication relating to (1) confidential legal advice regarding preparation for or information received in connection with board and committee meetings, (2) board governance matters, and (3) the consideration and addition of new independent trustees.

Generally speaking, the attorney-client privilege protects confidential disclosures made by a client to an attorney in order to obtain legal advice, as well as an attorney's advice in response to such disclosures, and communications made between an attorney and client in anticipation of litigation. The plaintiff argued that the attorney-client privilege should not protect the redacted and withheld documents, as a "fiduciary exception" to the privilege should be applied.

In a previous, unrelated case in which the fiduciary exception was applied to a common law trust, the U.S. Supreme Court held that the attorney-client privilege cannot be a basis for withholding information from the beneficiary of a trust when a trustee seeks or is provided legal advice to guide the administration of the trust. (*United States v. Jicarilla*, 564 U.S. 162 (2011)). Rather, the attorney-client privilege belongs to the trust beneficiaries, not the trustees, and only where the trustees show that they obtained legal advice for their own personal protection or independent personal purpose will the attorney-client privilege survive.

In the PIMCO case, the judge determined that the fiduciary exception applied to the redacted and withheld documents, relying on the Supreme Court case as precedent. The court found that, as a series of a Massachusetts business trust, the fund was "indisputably set up as a trust" with the shareholders as the trust's beneficial owners, that the independent trustees owed a fiduciary duty to the fund's shareholders, that the documents at issue contained legal advice for managing the fund rather than personal advice to the trustees, and that the communications were not made in anticipation of any litigation. Accordingly, the trustees were ordered to turn over the documents.

To date, the decision has not been appealed.

Source: Kenny v. Pacific Investment Management Company LLC, 2016 WL 6836886 (W.D. Wash. Nov. 21, 2016).

Salman v. United States: Supreme Court Ruling on Insider Trading

On December 6, 2016, the Supreme Court upheld the Ninth Circuit's insider trading conviction of Mr. Bassam Salman and ruled that the test for insider trading set out in *Dirks v. SEC* is satisfied when a tipper gifts inside information to a relative or friend who trades on the information. The decision is inconsistent with and overrules the portion of the Second Circuit's decision in *United States v. Newman* that requires the tipper and tippee to have a sufficiently close, personal relationship that generates pecuniary or other valuable gain for the tipper.

The inside information at issue in *Salman v. United States* originated from Mr. Maher Kara, an investment banker in Citigroup's healthcare investment banking group, who dealt with highly confidential information about mergers and acquisitions. Maher shared inside information with his older brother, Mr. Mounir "Michael" Kara, who, in turn, shared it with Mr. Salman, Michael's friend and Maher's brother-in-law. Whereas Mr. Salman was aware that the inside information originated with Maher, Maher did not know that Michael was passing the information on to Mr. Salman.

In *Dirks v. SEC*, the Supreme Court explained that liability for insider trading depends on whether the tipper's disclosure of inside information breaches a fiduciary duty. A breach of fiduciary duty occurs when the tipper obtains a "personal benefit" from disclosing the inside information. A jury can infer a personal benefit and, thus, a breach of fiduciary duty where the tipper either receives something of value in exchange for the tip or "makes a gift of confidential information to a trading relative or friend." That "gift giving principle," so labeled by the Supreme Court, arises from the idea that "when an insider makes a gift of confidential information to a trading relative or friend . . . [t]he tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."

The Supreme Court's decision in *Salman v. United States* hinged upon a circuit split surrounding conflicting interpretations of the "gift giving principle" set out in *Dirks*. While the case was pending, the Second Circuit in *Newman* held that *Dirks* does not permit a jury to infer a personal benefit to a tipper from a gift of inside information to a trading relative or friend unless there is "proof of a meaningfully close personal relationship . . . that generates an exchange that is objective, consequential, and represents at least a potential gain of pecuniary or similarly valuable nature" to the tipper. Ruling on Mr. Salman's appeal of his conviction in the court below, the Ninth Circuit declined to follow *Newman* and held that its jury could rightfully conclude that, consistent with *Dirks*, Mr. Salman's tipper personally benefited merely by making "a gift of confidential information to a trading relative."

Mr. Salman drew upon *Newman* in arguing that a gift of inside information to a friend or family member is insufficient to establish the personal benefit requirement for insider trading liability unless the tipper's goal in disclosing the inside information was to obtain money, property, or something of tangible value. The Government argued that a gift of confidential information to anyone, not just a "trading relative or friend," is enough to prove insider trading because a tipper personally benefits whenever the tipper discloses confidential information for a personal (non-corporate) purpose.

Applying the test for insider trading set out in *Dirks*, the Supreme Court in *Salman v. United States* reasoned that Maher, the tipper, committed insider trading when he disclosed inside information to his close relative, Michael, with the expectation that he would trade on it. Maher thereby breached his fiduciary duty to Citigroup and its clients. Mr. Salman, in turn, acquired and breached that same fiduciary duty by trading on the inside information with full knowledge that it had been improperly disclosed.

Salman v. United States has far-reaching implications for insider trading liability generally because it clarifies the "personal benefit" component of the insider trading test set out in *Dirks*: a tipper can be said to have received a "personal benefit" from disclosing inside information merely by "mak[ing] a gift of confidential information to a trading relative or friend," independent of the tipper's receipt of something of a "pecuniary or similarly valuable nature" in exchange for the gift.

Source: Salman v. United States, decided by the Supreme Court of the United States on December 6, 2016.

SEC Settles with Adviser for Improper Valuation of Bonds and Disclosure Failures

On October 18, 2016, the SEC announced that it had reached a settlement with Calvert Investment Management, Inc. in administrative proceedings arising out of Calvert's alleged improper fair valuation of illiquid bonds held by eight of the mutual funds it advises, the Calvert Funds. Without admitting or denying the SEC's findings, Calvert agreed to pay a $3.9 million civil penalty to the SEC.

According to the SEC's findings, between March 18, 2008 and October 18, 2011, the Calvert Funds acquired more than $1.2 billion principal amount of bonds issued by Toll Road Investors Partnership II, L.P. The bonds were complex illiquid securities with minimal external data points regarding pricing, and Calvert relied primarily on the output of a third-party analytical tool in conducting its valuation of the bonds. Calvert did not incorporate into its valuation important available market indicia of fair value, including the prices at which the Calvert Funds traded the bonds and the values assigned by other holders of the bonds. Calvert also failed to back-test the fair value calculations of the bonds, despite engaging in back-testing for other holdings.

On October 19, 2011, Calvert discovered that the third-party analytical tool it relied upon for valuing the bonds was flawed in that it failed to properly account for the future cash flows of the bonds. That flaw had the effect of substantially inflating Calvert's fair value prices of the bonds. After discovering the flaw, Calvert developed its own cash flow model to recalculate the fair value prices of the bonds. That reassessment resulted in a significant reduction of the fair value prices assigned to the bonds, which, in turn, resulted in a material reduction in the NAV of each of the Calvert Funds.

The SEC found that, as a result of Calvert's NAV error, the Calvert Funds executed transactions at the wrong NAV, reported inaccurate performance figures, and collected inflated asset-based fees. The SEC also found that Calvert's initial remediation effort—a one-time aggregate contribution of $27 million to the Calvert Funds and shareholders—was based on incorrect estimated loss amounts, did not conform to the Calvert Funds' NAV error correction procedures, and treated shareholders differently depending on whether they invested in the Calvert Funds directly or through an intermediary. Finally, the SEC found that neither Calvert nor the Calvert Funds disclosed to investors that the initial remediation did not conform to the Calvert Funds' procedures or that the remediation did not uniformly compensate shareholders.

Although Calvert had made an attempt at remediation by reimbursing the Calvert Funds $27 million and had distributed most of that amount to shareholders, the SEC determined that the reimbursement amount was based on an insufficient process and that Calvert had undercompensated some shareholders while failing to compensate other shareholders at all. The SEC found that this unequal treatment was due, in part, to Calvert's lack of information about shareholder activities in subaccounts held through intermediaries. The SEC directed Calvert to recalculate the fair value of the bonds for the period from March 18, 2008 through October 19, 2011, calculate new daily NAVs for each affected fund and each of those funds' affected share classes, and adjust the new NAVs to account for purchases and redemptions that occurred at the incorrect NAVs. The SEC then directed Calvert to make distributions to shareholders in the Calvert Funds based on the application of a specific distribution methodology detailed by the SEC. With respect to shares held in omnibus accounts, the distribution methodology required Calvert to obtain detailed underlying investor information from intermediaries in order to make the appropriate distributions to the ultimate shareholders. The SEC also required Calvert to submit its distribution plan, including information about each of the payees, to the SEC for approval and to make appropriate adjustments to its asset-based management fees.

Noteworthy in the SEC's order is the extent of the SEC's interest in correct valuation and the manner in which the SEC expects funds to remediate valuation errors to ensure uniform treatment of shareholders. The SEC prescribes a complicated methodology for reprocessing NAVs and an extensive process for working with intermediaries in connection with omnibus accounts to ensure that remediation is appropriate for each shareholder. With respect to remediation relating to shareholders investing through intermediaries, the SEC makes it clear that lump sum payments to distributors is insufficient. Instead, funds must determine appropriate reimbursement at the ultimate shareholder level and treat all shareholders uniformly, regardless of whether they invested directly in the fund or through intermediaries.

Source: In the Matter of Calvert Investment Management, Inc., Investment Advisers Act Release No. 4554 and Investment Company Act Release No. 32321 (October 18, 2016), available at https://www.sec.gov/litigation/admin/2016/ia-4554.pdf.

Excessive-Fee Litigation Update

Two partial summary judgment rulings in excessive fee litigation cases provide guidance as to the future of litigation under Section 36(b) of the Investment Company Act, which imposes a fiduciary duty on mutual fund advisers with respect to their receipt of compensation for services. Taken in connection with the plaintiffs' loss in *Sivolella v. AXA Equitable Life Insurance Company* that we reported on in our *October 2016 Update*, these developments signal courts' resistance to the theory of liability in which fee arrangements are deemed excessive because the fees received by advisers disproportionately exceed the fees received by their sub-advisers.

On November 15, 2016, the U.S. District Court for the District of Massachusetts granted partial summary judgment in favor of the adviser in *Russell Investment Management Company Shareholder Litigation*, finding that the process by which the board approved the fee arrangement was sound and, therefore, entitled to deference. The complaint alleged that the defendant adviser breached its fiduciary duty by, among other things, delegating all of its asset management responsibilities to sub-advisers while retaining a disproportionate amount of the fees. Specifically, the plaintiff alleged that the adviser received fees "290% greater" than the fees received by the sub-advisers. At the summary judgment hearing, the adviser presented evidence showing that the fee arrangement was commensurate with that of other advisers of funds with comparable performance, intended to compensate the adviser for significant services it provides beyond those provided by sub-advisers, and was approved by a super-majority of disinterested, well-qualified directors who received a broad range of information about the fees from the adviser, independent counsel, and third-party experts. Ruling from the bench, Judge William J. Young said that, although the board's approval of the fee arrangement is entitled to deference as a matter of law, the plaintiff "probably squeak[s] by summary judgment" on three issues: alleged ancillary fall-out benefits the adviser received as a result of managing the fund, the adviser's profitability in managing the funds, and the nature and quality of the adviser's services. The case is expected to proceed to trial in March.

The U.S. District Court for the District of New Jersey granted partial summary judgment in favor of the adviser in *Kasilag v. Hartford Investment Financial Services, LLC*, finding that the process by which the board approved the fee arrangement was sound and, therefore, entitled to deference. As in *Russell*, the complaint alleged that the defendant adviser breached its fiduciary duty by, among other things, delegating all of its asset management responsibilities to sub-advisers while retaining disproportionately large fees. The parties completed a four-day bench trial on November 16, 2016, which included the testimony of competing experts in economics, the financial industry, and accounting, as well as the adviser's chief investment officer, who testified about the services provided by the adviser, the adviser's fee structure, and the funds' performance. A decision is expected in the spring.

Sources: Kasilag v. Hartford Investment Financial Services, Case 1:11-cv-01083-RMB-KMW (D.N.J. 2016); McClure v. Russell Commodity Strategies Fund, Case 1:13-cv-12631-WGY (D. Mass.); Notable Developments in Excessive Fee Litigation, American Bar Association (November 28, 2016), available at http://www.americanbar.org/publications/litigation-committees/securities/practice/2016/notable-developments-in-excessive-fee-litigation.html.