Client Alert

October 21, 2015

SEC Settles Charges that Investment Adviser Failed to Adequately Disclose Changes in Investment Strategy

By Kelley Howes

The SEC settled charges with two investment advisers to a closed-end fund based on allegations that the advisers failed to adequately disclose a change in investment strategy to the fund's board and its investors. The SEC also found that shareholder reports filed with the SEC were inaccurate.

According to the SEC, the fund originally invested in distressed debt, but, in 2008, it began investing a significant portion of the fund's assets in credit default swaps (CDS). Prior to 2008, the market value of the CDS portfolio never exceeded 2.6% of the fund's net assets. The SEC found that by the end of the first quarter of 2009, however, the fund's CDS portfolio grew to 25% of net assets.

Since CDS values move significantly more than traditional bond prices in response to credit market fluctuation, the increase in exposure to CDS meaningfully changed the fund's risk profile. According to the SEC, this represented a shift from an investment thesis that debt would *increase* in value to an investment thesis that debt would *decrease* in value. The SEC found that the change in investment strategy resulted, at least in part, in significant losses, and the fund was liquidated in 2012.

Pursuant to the fund's offering memorandum, the fund was authorized to buy and sell securities other than distressed debt, including derivative instruments for both hedging and speculative purposes. The offering memorandum included general risk disclosure related to investments in derivatives, but the SEC found that it did not contain adequate specific disclosure related to the risks of holding CDS.

The SEC found that the fund's advisers misrepresented the investment strategy in communications to investors and the fund's board, as well as in filings with the SEC. For example, according to the SEC:

- the investment strategy in the fund's offering memorandum was not updated to reflect the change from long credit to short credit;
- the board was not advised of the results of a stress test showing large potential CDS losses for the fund;
- the board was not advised about the substantial cost of maintaining CDS positions;
- the advisers provided potential investors with a marketing brochure that represented the fund followed a long-credit investment strategy and used CDS only occasionally;
- current investors in the fund were provided with investor letters that did not adequately disclose the fund's use of leverage and included performance comparisons to benchmark indices that the SEC found were not appropriate; and

- the fund's investment strategy was not accurately disclosed in shareholder reports filed with the SEC.

The SEC found that one of the advisers had "contractual control and supervisory authority" over the other because, under relevant agreements, it had unlimited authority to "manage and direct . . . the investment activities of [the fund]." The SEC found that the supervising adviser had real-time access to the fund's holdings and held discussions with the other adviser's principal regarding the fund's CDS exposure. Nonetheless, the SEC found that the supervising adviser failed to ensure that the other adviser adhered to the fund's stated strategy and provided the board and investors with accurate disclosure.

Without admitting or denying the allegations, the advisers agreed to compensate fund investors for losses attributable to the change in the fund's investment strategy. Losses were computed by comparing the fund's actual performance to that of a hypothetical portfolio in which the market value of CDS positions was limited to no more than 10% of the fund's net assets. The SEC staff determined that the 10% threshold was the point at which the fund deviated from its stated investment strategy. Distributions to shareholders will total more than $13 million.

In addition, the advisers were jointly and severally assessed a civil money which, together with pre-judgment interest, totals more than $4 million.

Our take: The SEC Chair has announced that the SEC will soon be issuing proposed rules related to funds' use of derivatives and the resulting effect of leverage on funds' performance. This order may provide some insight into the types of concerns that the proposed rules will address: accurate and clear disclosure to fund investors; appropriate discussions with a fund's board to ensure it can adequately perform its oversight role; and ensuring that filings with the SEC contain accurate information. Funds and their advisers should carefully review their current disclosure practices to ensure that they are adequately representing the use of derivatives and that they continue to operate within the parameters of their stated investment strategy

Contact:

Kelley Howes
(303) 592-2237
khowes@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for 12 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.