Note: All statutory references are to section numbers *as codified*. As such, 15 USC 80a-2 is referred to as §2, etc.

Question 1:

I was unfamiliar with the term "registered representative," and am operating under Investopedia's definition[1], which suggests that Smith is *not* registered as an Adviser. All statutory citations in this question are to the Investment Advisors Act (IAA) unless stated otherwise.

The first question is whether Smith should presently be registered as an Investment Advisor, and if so when that registration should have occurred. An Investment Adviser is generally anyone who provides investment advice for compensation per §2(11). There are, however, a number of exceptions, including "any broker . . . whose performance of such services is solely incidental to the conduct of his business . . . and who receives no special compensation therefor" under §2(11)(C). The initial website with general investment advice and no additional fee clearly meets this exception as discussed by Rule 202(a)(11)-1, and so he was not required to register as an adviser upon creating the website.

Once Smith began to charge for his personal stock selections, he received special compensation, and so does not fall under the exception *if* the information he provided constituted Advice. Smith is clearly giving advice by analogy to *Gun Soo Oh Park* (Book p. 57), who operated a website disseminating stock picks and giving specific advice and was found in violation of the IAA, and *Lowe* (Book, p. 54) who met the publication exception in part because his advice did not target a specific portfolio (e.g. his own stock picks). So Smith was in violation of the IAA unless he fit into an exception. Fortunately for him, Smith is excepted from the Act if he has less than $25,000,000 under management, *unless* he is under the control of Mural and Mural is an Advisor. (Rule0-7)

Smith has a couple of problems due to his actions if he is an adviser. First, he failed to register as required and to make the mandatory disclosures. For this he faces both civil and criminal penalties under §§9(e) and 17 respectively. Further, Smith's use of his own account for client funds is a clear violation of Rule 206(4)-2, which makes it a felony to have "custody of client funds or securities" unless a those funds are with qualified custodian and certain other conditions are met. As the facts suggest that he used his personal account as a slush account for client funds, he is clearly in violation of the Act.

[1] http://www.investorwords.com/4130/Registered_Representative.html

Turning to Mural, it is aware of, and indeed approved Smith's actions. If Mural is an Advisor under the Act, the SEC might institute a proceeding under §3(e) to censure Mural for failing to supervise Smith. Accordingly, I would advise Mural to discuss the matter with the SEC and reach an appropriate resolution lest Mural have its registration revoked.

Question 2:

The problem does not suggest that Smith has registered the “portfolios” as investment companies, so the main issue is whether some entity, be it Smith, Mural or the portfolios (collectively “SMP”) is an Investment Company under the meaning of the Investment Company Act. Turning to the definition of an “Investment Company” under §3(a)(1), the first issue is whether SMP is an Issuer, which is one who issues, proposes to issue, or has issued currently outstanding securities, per §2(a)(22). Mural allows Smith to hold the clients’ assets in his own account, and acts merely as a broker. Accordingly Mural’s connection to the transactions does not seem closely tied enough that it would be subject to the Act for Smith’s activities. Accordingly, we next turn to whether Smith issued Securities representing the clients’ portfolios.

My understanding of the facts are that Smith provides default portfolio configurations that the clients are allowed to change on a periodic basis (or at time of purchase). Although Smith recommends default portfolios, his clients are free to change the structure such that his clients’ investments lack the uniformity that we saw in *Howey* (uniform plots of trees) and *Bank of America Canada*. Accordingly, he does not appear at first glance to be issuing securities.

If my understanding of the facts, however, is not entirely accurate and Smith is instead creating uniform chunks of assets to be purchased by portfolio investors, e.g. a share of his real estate holdings rather than a specific house,[2] he might have the requisite uniformity to constitute securities. If the clients’ investments are essentially shares of underlying securities and thus constitute securities in and of themselves, then Smith is an Issuer under the meaning of the Act.

If Smith is found to be an issuer, we must ask if the portfolios are or propose to be engaged primarily in the business of investing (§3(a)(1)(A)). The analysis would seem to be duplicative of whether or not Smith is an Issuer. If he is an Issuer, it is because he is issuing securities of securities, and thus he must be engaged in the business of investing. He might try to wiggle out of this clause by arguing that he is not *primarily* engaged in investing, however that seems attenuated as the amount of work involved means that assuming a growing client base he is decidedly *proposing to be primarily engaged* in investing.

[2] I note that real property, is considered by the legal community to be decidedly non-uniform and non-fungible, and thus is the classic example where a dispute would create a presumption of specific performance of a contract.

My understanding of the facts is that the Smith is acting as an agent for his customers, and so never actually owns the underlying securities as was the case in *Howey* and *Bank of America*. As the portfolios seem to be acting as broker/advisors rather than investment companies, they do not appear to be holding the securities, and thus do not constitute investment companies. Accordingly, they are not subject to the Act.

If my understanding is not correct, and Smith is an Issuer as discussed above, it is possible that he may be exempted from the Act under §3(c)(1). This would be the case if (i) Smith has no more than 100 investors and (ii) is not making and does not propose to make a public offering. I read the problem as saying that Smith has less than 100 investors, as it says his "brokerage services . . . grew to over 75 clients." If he only allows his previous clients to invest in "portfolios" or otherwise does not have a private offering, he will meet the exception. Further, having a website does not preclude exemption so long as it is behind access controls.[3]

Further, Smith is excepted under §3(c)(7)(A) if he is not making and does not propose to make a public offering as described and all of his investors were Qualified Purchasers, as defined in §2(a)(51), at the time they purchased Smith's securities. A Qualified Purchaser is most commonly natural person who has invested over $5,000,000 or a person or company acting for other qualified purchasers and managing not less than $25,000,000. Note, however, that if Smith is excepted under §3(c)(7)(A), he is still subject to certain provisions of the act under §3(c)(7)(D).

[3] See Lamp Technologies No-Action Letter, Book p. 126.

Question 3:

Assuming that Fundelity has registered as an Advisor under the Investment Advisors Act, the first question is whether Lunch (and later Dale) must register as Advisors. They clearly fall under the scope of §202 (11), and thus must register.

First, the fact pattern never explicitly states that the Fund registered as an Investment Company. As Fundelity is a large organization that has considerable expertise with how and when to register, I assume that this was taken care of in full. Further, because only post-registration performance may be advertised, all ten of the incubator funds must have been registered at the outset. [4] As such, my analysis assumes that all ten funds were registered at their inception.

Second, there is no mention of the advisory contract at all. The contract must be fairly specific and approved by the shareholders, and depending on the contract's specification that Lunch remain at the helm might have to be renewed upon his departure. I assume that this, also, was generally taken care of by Fundelity because they have considerable expertise in the Mutual Fund arena.

Third, there is a strong analogy here to the facts of *Van Kampen* (Book, p. 196). There the company used an "incubator fund" that invested heavily in small IPOs in a manner that could not be sustained on a larger scale, and the impact study found that, as here, 1/3 of the fund's growth was due to those IPOs. As the facts of the Leader Fund do not suggest that this information was disclosed to the public investors, there was a failure to disclose material information.

Further complicating this is Lunch's contract with Fester. The first question is who the contract is with – Lunch or each of the Ten Funds (or, for that matter, Fundelity). Note that I understand Leader Fund to be one of the Ten Funds. If the contract was with Lunch, it would be a clear conflict of interest, as Lunch is trading Fund business for his personal benefit (even if he used it for the fund, as here). Additionally, if the contract was with Lunch, the Fund's access to those IPO investments would leave with Lunch, and thus they have another disclosure of material information problem. If the contract were with the Fund, it would be a transaction with an affiliated person (Fester, acting as the broker) and so would be subject to scrutiny under §17. Both Lunch's paid-for invitation to the annual Bahamas event and the laptop would be problematic under §17(e)(1) in either case, as Lunch is accepting benefits

[4] Alan R. Palmiter & Ahmed E. Taha, *Star Creation: The Incubation of Mutual Funds*, 62 Vand. L. Rev. 1485, 1519 (2009).

from a third party for actions as an agent of the Fund. While this situation resembles that of soft dollars (which, as we discussed, is a highly problematic subject), the benefits to Lunch are clearly accrued at the Fund's expense. As such, the contract is illegal. As the historical performance is due to an illegal (and thus unenforceable) contract, the past performance data sent to the investors was woefully deficient. Additionally, the fact that brokerage commissions were to be determined at time of trade suggests that Lunch may have breached his fiduciary duty by not negotiating the best contract for the Fund.

Also, the intent from the outset to merge the High Flyer Fund ("HF") into the Leader Fund further speak to the fraud on investors by claiming the Leader Fund's first-year performance. As the merger may have high associated costs that the new shareholders of the infant Leader Fund may have to bear in large part, that intent probably should have been disclosed to the investors. If, however, Fundelity is able to manage the merger such that the Fund Investors do not have to pay for it (this is discussed further in Question 4) the ICA should be satisfied.

Lastly, there is no discussion in the fact pattern as to whether or not the SEC approved the ads that Fundelity ran. Advertisement is governed by the Investment Advisors Act, Rule 206(4)-1. As I do not have enough information to analyze the advertisements in their entirety, describing the gains as "phenomenal" may be interpreted to be more than mere puffery, and thus outside the bounds of acceptable advertisement.[5]

As to the issues identified here, Fundelity must urgently seek to rectify them where possible, and will want to immediately consider approaching the SEC about uncovering and rectifying these issues openly.

I discuss all further issues associated with the merger of the two funds in Question 4.

[5] I note that the description of the incubator fund's gains as "phenomenal" also parallels *Van Kampen*, where there does not seem to be an action for misleading advertising separate from the claim for failure to disclose material information.

Question 4:

The wording of the problem suggests that they two fund companies are going to merge in a legal sense, which is to say by becoming one legal entity. As the language of Question 5 *strongly* suggests a legal merger, I operate under the assumption that that is what Fundelity plans to do.

As each of the Ten Funds except the Leader Fund is to remain private, they will need to either close or deregister with the SEC as they are not Investment Companies per §3(a)(2)(c). Aside from the merger question, all of the actions that Fundelity and Leader Fund must take were outlined in Question 3. Before Fundelity can move forward with the merger of the Leader Fund (the "Fund" or "LF") and the High Flyer Fund ("HF"), both funds need to have a board of directors to whom decisions will be put (see discussion in Question 5).

The state law merger process, in very brief, works like this: The fund boards will have to agree on a price that LF will pay for each share of HF, likely some number of whole or partial LF shares. The boards approve the merger and submit it to the shareholders of both funds.[6] When the merger executes, HF shareholders get the agreed-upon payment (likely shares of LF), and LF gets all of HF's assets. Of course, many of those assets will be either poor investments or counter to LF's investment strategy (as filed with the SEC and in its disclosures), and so LF will have to sell them, for which there may be significant tax or financial consequences.[7]

The one **big** complexity would be if HF had existing exemptions that Fundelity wanted to retain. In that case, it would have to be the surviving fund, and would have to change its investment strategy, and Advisory contract, as well as losing all positive performance history. As such, I assume that LF will be the surviving corporation.

The first step is for the boards to get together and discuss the merger. They have to agree upon a price and approve the merger, ensuring that the valuation of the other fund's assets is fair and accurate. Then they submit it to the shareholders of both companies for approval. The shareholders of HF would have to approve the change in investment strategy per §8(a)(2), however that seems to be

[6] There are additional complexities. For instance a very large company may not need shareholder approval to buy a very small one. The small one would still need approval. Because LF is new, I assume that its size is roughly comparable to HF's, and give this as a very brief partial illustration.
[7] See generally http://www.businessweek.com/2000/00_51/b3712222.htm.

satisfied because (a) the HF shareholders have to approve the transaction in the first place and (b) HF will cease to exist after the merger. Finally, the funds merge by operation of law, and HF seeks to exist.

Question 5:

I begin by noting that because the High Flyer Fund is likely incorporated as a corporation, the process of electing directors may be subject to the laws of the state of incorporation. These laws are not discussed here.

Haley's desire to remove Unio from the slate of proposed directors does not seem overly problematic. The slate is merely proposed, and does not yet appear to have been sent to Fund's investors, so I do not see any issues under the '40 Act. There is a possibility that action against Unio may be actionable under the Sarbanes-Oxley Act (SOX) and related whistle-blower statutes, however Unio's threat is so amorphous that those statutes may not be invoked. Further, assuming the Fund handles the issues discussed in Questions 3 & 4, Unio seems to be threatening to disclose public information.

This answer assumes that the fund will have 11 directors,[8] none of whom own or control at least 5% of the Fund unless otherwise stated. A fund's directors must typically be at least 40% disinterested (per §10(a)), as determined by §2(a)(19). Each of the first seven proposed directors are interested as they are affiliated persons under §2(a)(3). The retired executive does not appear to be interested. He is not an affiliate under §2(a)(3)(D), as that applies only to *current* employees. Further, many mutual fund "independent" directors consist of ex executives of an affiliate.[9] The father in law appears to be interested under §2(a)(19)(ii). The final paragraph of §2(a)(19) lays out the scope of an affiliated person's (in this case the portfolio manager) immediate family. While the definition *might* be interpreted to exclude parents in law, in includes the spouses of adoptive and step children, thus seeming to acknowledge the person's spouse's relations as being equivalent to the person's. If a son in law is a person's "immediate family" it would be inconsistent if the inverse were not so. The partner at White and Casey is interested as he is an affiliate under §2(a)(19)(iv). Lastly, Unio may be interested depending on how much, if any, of the Leader Fund his pension controls. If they control at least 5% of the Fund, he is interested under s §2(a)(3). As the percentage of disinterested directors falls considerably short of the requisite 40%, the Fund must rectify the ballot of proposed directors to ensure that at least five disinterested directors are ultimately elected.

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[8] I note that given 11 directors, 5 of them constitutes 45% of the directors.

[9] Victor Brudney, *The Independent Director: Heavenly City or Potemkin Village?*, 95 Harv. L. Rev. 597, 599 n.3 (1982) ("almost half of the 'outsiders' on the boards studied have a relationship with the company (e.g., supplier, customer, banker, lawyer, retired employee, or relative of executive)").