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A legal update from Dechert's Financial Services Group

# SEC Settlements Impose Cease-and-Desist Orders and Penalties Against Investment Advisors for Noncompliant Dividend Distribution Disclosures and Misleading Statements

## Introduction

Recent Securities and Exchange Commission ("SEC") actions in four administrative proceedings illustrate the SEC's heightened scrutiny of required dividend distribution disclosures and the need for registered investment companies to review their compliance procedures to avoid penalties. These proceedings involved failure to disclose in dividend distribution notices that the distributions were made from shareholder capital and other violations of the dividend reporting requirements under Section 19(a) of the Investment Company Act of 1940 ("Act") and Rule 19a-1 thereunder.[1] Two of the cases also involved violations of the antifraud provisions of Section 34(b) of the Act.[2] Without admitting or denying the SEC's findings, each of the parties settled the charges by agreeing to the issuance of a cease-and-desist order and payment of civil penalties.

## Discussion

Section 19(a) of the Act prohibits registered investment companies from paying any dividend or making any distribution in the nature of dividend distributions from any source other than net income unless the payments are accompanied by contemporaneous written statements to shareholders identifying the sources of the distributions. Rule 19a-1 under the Act specifies that the written statement must be on a separate paper and clearly indicate what portion of the payment is from: (1) net income (not including capital gains); (2) capital gains; or (3) paid-in surplus or other capital source. The purpose of Section 19(a) and Rule 19a-1 is to ensure that shareholders are not misled into believing that a portfolio is generating investment income if distributions are in fact being paid from other sources.[3]

Section 34(b) is the Act's anti-fraud provision that makes it unlawful for any person to make an untrue statement of material fact in any document filed with the SEC, or to omit material information necessary to make other statements made therein not misleading.

### The Putnam Order

From August 1, 2000, to May 31, 2002, Putnam Investment Management, LLC ("Putnam") served as the adviser for four closed-end

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1 *See In the matter of Putnam Investment Management, LLC*, Rel. IC-28003 (Sept. 28, 2007) (the "Putnam Order"); *In the Matter of AllianceBernstein, L.P.*, Rel IC 28002 (Sept. 28, 2007) (the "Alliance Order"); *In the Matter of Salomon Brothers Asset Management Inc.*, Rel IC-28004 (Sept. 28, 2007) (the "Salomon Brothers Order"); *In the Matter of Smith Barney Fund Management LLC*, Rel IC-28005 (Sept. 28, 2007) (the "Smith Barney Order").

2 *See Salomon* and *Smith Barney*, *supra* note 1.

3 *See* Rule 19a-1(g): "[t]he purpose of this section, in the light of which it shall be construed, is to afford security holders adequate disclosure of the sources from which dividend payments are made." *See also* SEC Release No. 71, 1941 (Feb. 21, 1941) ("An important feature of the rule is the extent to which it requires explicit and affirmative disclosure whenever a dividend is being paid from a capital source").

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investment companies registered under the 1940 Act (the "Putnam Funds"). Putnam also was responsible for the administrative operations of the Putnam Funds.

The Putnam Funds made distributions to shareholders from shareholder capital without providing a written statement identifying the source of the Funds. Though Putnam did send written notices with the distributions, the notices did not inform shareholders that the distributions were from shareholder capital.

Putnam defended its failure to provide the required notices on grounds that the specific source of each distribution could not be definitively determined until the end of the fiscal year. Putnam's monthly monitoring process included projecting whether there would be a return of capital at the end of the fiscal year and adjusting the dividend rate based on those projections to prevent a return of capital. Thus, it would not be clear whether a distribution was shareholder capital or net income until the end of the fiscal year.

The SEC countered by citing Rule 19a-1(e), which mandates reasonable estimates of the source of each dividend at the time of payment.[4] Thus, while Putnam's projections and adjustment of dividend rates might change the nature of the distribution by the end of the fiscal year, it was still required to inform shareholders of the Fund's best estimate regarding the source of that distribution at the time it was paid.

Additionally, while Putnam later provided shareholders with Internal Revenue Service ("IRS") Forms 1099-DIV, which identified the source of the distributions as shareholder capital, the notices did not comply with Section 19(a) and Rule 19a-1 because they were not made contemporaneously with each distribution.

Putnam agreed to pay a civil money penalty of $350,000 to settle the proceeding.

**The Alliance Order**

AllianceBernstein, L.P. ("Alliance"), served as the adviser for two funds (the "Alliance Funds") during the period between January 1, 2002, and July 9, 2004.

4 *See* Rule 19a-1(e): "the source or sources from which a dividend is paid shall be determined (or reasonably estimated) to the close of the period as of which it is paid."

The Alliance Funds' managed distribution policies required the Funds to make fixed quarterly payments equal to 2.5% of Net Assets Value ("NAV") regardless of their performance. The policies further provided that any shortfall between the distribution and the net investment income and short-term capital gains would be funded with shareholder capital or long-term capital gains.

During the relevant period, the Alliance Funds made several distributions from shareholder capital and capital gains. While Alliance did provide shareholders with distribution notices, the notices did not comply with the requirements of Section 19(a), because they failed to inform shareholders that the dividends were paid from shareholder capital and capital gains. Several of the notices failed to mention the source, while other notices misstated that the source of the distributions was investment income. Additionally, while Alliance provided shareholders with IRS Forms 1099-DIV, which identified the source of the distributions as shareholder capital, those notices did not comply with Section 19(a) and Rule 19a-1, because they were not made contemporaneously with each distribution.

Alliance agreed to pay a civil money penalty of $450,000 to settle the proceeding.

**The Salomon Brothers Order**

From January 1, 2001, through April 30, 2003, Salomon Brothers Asset Management Inc. ("Salomon Brothers") was the adviser to two closed-end funds (the "Salomon Funds"). Salomon Brothers also provided administrative services to the Funds and was responsible for filing annual reports with the SEC. The Salomon Funds paid distributions from shareholder capital, and while written notices accompanied the distributions, the notices failed to satisfy Rule 19a-1, because they did not inform shareholders that the distributions were partly from shareholder capital.

Salomon Brothers filed annual reports for the Funds in which the Manager's Discussion of Financial Performance ("MDFP") section disclosed an annual dividend without disclosing that the figure included returns of shareholder capital. For example, although the Financial Highlights section of one Fund's report showed that $0.14 of the $1.00 distribution was from shareholder capital, the MDFP section stated only that "[d]uring the year ended December 31, 2002, the Fund distributed dividends to shareholders totaling

$1.00 per share." The SEC alleged that, in failing to disclose that a portion of the dividends came from shareholder capital, Salomon Brothers made untrue statements by implying that the distributions were entirely from Fund net income, and thus that the Salomon Funds had greater returns than was the case. According to the SEC, Salomon Brothers violated Section 34(b) by including these untrue statements in the annual reports.

Further, the yield figure in the MDFP sections assumed an annual dividend paid entirely from net income. For example, the annual report of one Fund states that the annualized distribution rate was calculated based on the "current monthly income dividend rate of $0.080 [per share] for 12 months." However, 14% of the distributions were actually a return of shareholder capital, not income. The SEC reasoned that by including the return of shareholder capital in the calculation of annualized distribution rates, Salomon Brothers implied that the current monthly distributions were entirely from net income, and thus that the Salomon Funds had greater returns than was the case. According to the SEC, these were material omissions or misstatements regarding the Salomon Brothers Funds' performance, and Salomon Brothers violated Section 34(b) by including them in the annual reports.

Salomon Brothers agreed to pay a civil money penalty of $450,000 to settle the proceeding.

**The Smith Barney Order**

Smith Barney Fund Management LLC ("Smith Barney") served as the adviser to three closed-end funds (the "Smith Barney Funds") during the period from March 1, 2001, to September 30, 2004. Pursuant to agreements with the Funds, Smith Barney was responsible for providing Section 19(a) notices to shareholders and filing annual reports with the SEC. During this time period, the Smith Barney Funds each made distributions to shareholders from shareholder capital without providing the proper Section 19(a) notices. Although notices accompanied the distributions, the notices did not properly disclose the source of the distributions, as required by Section 19(a) and Rule 19a-1.

Additionally, the MDFP section of the annual reports disclosed an annual dividend without indicating that the figure included returns of shareholder capital. The SEC alleged that, in failing to disclose that a portion of the dividends came from shareholder capital, Smith Barney made untrue statements by implying that the distributions were entirely from Fund net income, and thus that the Smith Barney Funds had greater returns than was the case. According to the SEC, Smith Barney violated Section 34(b) by including these untrue statements in the annual reports.

Further, the yield figures included in the MDFP sections of the annual reports assumed an annual dividend paid entirely from net income. For example, the annual report for one Fund stated that the Fund had an annualized distribution rate that was based on the "current monthly income dividend rate of $0.0570 [per share] for 12 months." However, a portion of the distributions cited included returns of shareholder capital, and was not entirely income. The SEC reasoned that by including return of shareholder capital in the calculation of the annualized distribution rates, Smith Barney implied that the current monthly distributions were entirely from Fund net income, and thus that the Smith Barney Funds had greater returns than was the case. The SEC alleged that these were material omissions or misstatements regarding the Smith Barney Funds' performance, and that Smith Barney violated Section 34(b) by including them in the annual reports.

Smith Barney agreed to pay a civil monetary penalty of $450,000 to settle the proceedings.

## Conclusion

These cases show that the SEC inspection staff is looking for violations of Section 19(a) and Rule 19a-1. Registered investment companies should review their compliance procedures to ensure that those procedures adequately address this issue.

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