Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Guidance Regarding Gifts and Entertainment under Section 17(e)(1)

In February 2015, the staff of the Division of Investment Management of the SEC published a Guidance Update reminding mutual fund industry participants of the conflicts of interest that arise when investment adviser personnel accept gifts or entertainment from persons doing business, or hoping to do business, with a fund.

Section 17(e)(1) of the 1940 Act generally prohibits affiliated persons of a fund (e.g., an investment adviser or its personnel) from accepting any sort of compensation (other than regular salary or wages from the fund) for the purchase or sale of property to or for the fund if the affiliated person is acting as agent for the fund. The staff reaffirms its previous interpretation that compensation under Section 17(e)(1) includes gifts and entertainment. The staff notes that the receipt of gifts or entertainment by fund affiliates should be addressed in the fund's compliance policies and procedures required by Rule 38a-1 under the 1940 Act. The staff suggests that the particular content of a fund's policies and procedures concerning the receipt of gifts and entertainment will depend on the nature of the adviser's business. However, the staff cites a blanket prohibition on receiving gifts or entertainment or use of a pre-clearance mechanism for the acceptance of gifts or entertainment as possible measures to address the Section 17(e)(1) prohibition.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2015-01.pdf.

SEC Proposes Rules for Disclosure of Hedging by Employees, Officers and Directors

On February 9, 2015, the SEC proposed amendments to its proxy rules to implement Section 955 of the Dodd-Frank Act. Section 955 added a new Section 14(j) to the Exchange Act that directs the SEC to require by rule each issuer to disclose in any proxy or consent solicitation material for an annual meeting of shareholders whether any employee or member of the board of directors of the issuer is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities either granted to the employee or director by the issuer as part of the compensation of the employee or director, or held, directly or indirectly, by the employee or director.

The SEC proposes to implement Section 14(j) by adding a new paragraph (i) to Item 407 of Regulation S-K to require companies to disclose in proxy or information statements with respect to the election of directors whether they permit any employees (including officers) or directors to hedge their company's securities by engaging in transactions with the economic consequences comparable to the financial instruments specified in Section 14(j). With respect to registered investment companies, the SEC proposes that the new rules apply only to closed-end funds that are listed and registered on a national securities exchange because they typically hold annual meetings to elect directors and hedging transactions might be more likely with listed closed-end funds, which often trade at a discount, than with open-end funds or exchange-traded funds. The SEC stated that the hedging information may be important to the voting decision of an investor when evaluating fund directors, including considering whether directors may be more or less incentivized as a result of holding shares to seek to decrease a fund's discount. The SEC also noted that officers and directors of listed closed-end funds are already required to report hedging transactions under Section 16(a) of the Exchange Act.

Comments on the proposed amendments are due by April 20, 2015.

Other News

SEC Asset Management Unit Co-Chief Discusses Enforcement Priorities

In a February 26, 2015 speech entitled "Conflicts, Conflicts Everywhere," Julie M. Riewe, Co-Chief of the SEC Division of Enforcement, Asset Management Unit (AMU), discussed the AMU's 2015 enforcement priorities, emphasizing conflicts of interest as an "overarching, perennial priority." She stated that the AMU divides the asset management industry into three categories by investment vehicle: registered investment companies, private funds (both hedge funds and private equity funds) and other accounts (such as separately managed accounts), with each vehicle presenting unique risks and thus warranting tailored enforcement priorities.

As to registered investment companies, Ms. Riewe identified the following priorities:

- valuation, performance and advertising of performance;
- funds deviating from investment guidelines or pursuing undisclosed strategies;
- fund governance, including boards' and advisers' discharging of their obligations under Section 15(c) of the 1940 Act when they evaluate advisory and other types of fee arrangements; and
- fund distribution, including whether advisers are causing funds to violate Rule 12b-1 by using fund assets to make distribution payments to intermediaries outside of the funds' Rule 12b-1 plan, whether funds' boards are aware of such payments, and how such payments are disclosed to shareholders.

Ms. Riewe concluded her speech with a focus on the AMU's "overarching" concern with conflicts of interest, as relevant to all types of investment vehicles. She noted that, in nearly every open matter, at least in part, the AMU is examining whether the adviser in question has "discharged its fiduciary obligation to identify its conflicts of interest and either (1) eliminate them, or (2) mitigate them and disclose their existence to boards or investors."

Specifically, Ms. Riewe noted her expectation that the AMU will recommend a "number of conflicts cases for enforcement action, including matters involving best execution failures in the share class context, undisclosed outside business activities, related-party transactions, fee and expense misallocation issues in the private fund context, and undisclosed bias toward proprietary products and investments." Citing the Distribution in Guise Initiative, Ms. Riewe also identified the "conflicts presented by registered fund advisers using fund assets to grow the fund and, consequently, the adviser's own fee" as ripe for enforcement action.

The full text of Ms. Riewe's remarks can be found at
www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html#.VRsP7ph0y_A

SEC and FINRA Issue Results of Cybersecurity Examinations

On February 3, 2015, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a Risk Alert providing summary observations derived from the staff's sweep examinations of over 100 registered broker-dealers and investment advisers that were undertaken to assess the cybersecurity practices and preparedness of such firms (the Cybersecurity Examination Initiative). On the same day, FINRA published a detailed, 46-page Report on Cybersecurity Practices identifying effective practices for dealing with cybersecurity threats, a product of its own 2014 targeted examinations of member firms and related initiatives, including a 2011 cybersecurity survey of its registered broker-dealers.

OCIE Risk Alert

In implementing the Cybersecurity Examination Initiative, OCIE staff interviewed key personnel and evaluated information and materials from 57 registered broker-dealers and 49 registered investment advisers[1] relating to the firms' practices for: identifying cybersecurity-related risks; establishing cybersecurity governance, including policies, procedures and oversight processes; identifying and responding to risks relating to service providers, vendors and other third parties; safeguarding network infrastructure and information; identifying and managing risks associated with remote access to client information and funds transfer requests; and uncovering unauthorized activity. The Risk Alert states that the staff's inquiries and document reviews were "designed to discern basic distinctions among the level of preparedness of the examined firms."

Notable observations in the Risk Alert include (figures pertain to examined firms):

- 88% of broker-dealers and 74% of investment advisers reported cyber-attacks directly or through one or more vendors, the majority of which arose from malware and fraudulent emails.
- 93% of broker-dealers and 83% of the investment advisers have adopted written information security policies.
- The written information policies and procedures of "only a small number" of broker-dealers (30%) and investment advisers (13%) contain provisions addressing how firms determine whether they are responsible for client losses associated with cyber incidents; even fewer of the broker-dealers (15%) and advisers (9%) offer security guarantees to protect clients against losses related to such incidents.
- 88% of the broker-dealers and 53% of the investment advisers reference and/or incorporate published cybersecurity risk management standards in their information security policies, such as those of the National Institute of Standards and Technology, the International Organization for Standardization, and the Federal Financial Institutions Examination Council.
- The "vast majority" of the broker-dealers (93%) and investment advisers (79%) conduct periodic risk assessments on a firm-wide basis to detect cybersecurity threats, weaknesses and potential business consequences, and use these assessments to establish their cybersecurity policies and procedures.
- Although most of the broker-dealers (84%) require cybersecurity risk assessments of vendors with access to their firms' networks, only 32% of the investment advisers have such requirements for vendors. A large majority (72%) of the broker-dealers incorporate requirements relating to cybersecurity in vendor contracts, but only 24% of investment advisers do.

1 Appendices to the Risk Alert provide breakdowns of the types of broker-dealers and advisers examined. Notably, of the total assets under management of the investment advisers examined, only 2% was accounted for by registered investment companies they advise, with the majority of clients categorized as "Diversified/Institutional."

- Almost all broker dealers (98%) and investment advisers (91%) make use of data encryption in some form.
- A majority (58%) of broker-dealers maintain insurance that covers losses and expenses attributable to cyber security incidents, but only 21% of investment advisers do.

The Risk Alert focuses more on the existence of cybersecurity controls, rather than their quality, noting that the exams "did not include reviews of technical sufficiency of the firms' programs." The Risk Alert cautions that OCIE staff is "still reviewing the information [obtained in the sweep exams] to discern correlations between the examined firms' preparedness and controls and their size, complexity, or other characteristics." Citing OCIE's announced examination priorities for 2015, the Risk Alert states that "OCIE will continue to focus on cybersecurity using risk-based examinations."

FINRA Report on Cybersecurity Practices

FINRA's 2014 cybersecurity examination of registered broker-dealers had four primary objectives: (1) to better understand the types of cybersecurity threats that are relevant to firms; (2) to increase understanding of "firms' risk appetite, exposure and major areas of vulnerabilities in their information technology systems"; (3) to assess firms' processes and procedures for managing these threats; and (4) to share observations and findings with member firms. The FINRA Report provides detailed discussions of firm practices using selected case studies, and offers critical guidance for firms to develop or advance their cybersecurity programs in light of the "threat landscape," in particular the three top cybersecurity threats identified by broker-dealers: hackers attempting to penetrate firm systems, insiders compromising firm or client data and operational risks.

The FINRA Report lists key principles and effective cybersecurity practices, including the following:

- Firms should have a sound governance framework with sound leadership, including direct engagement by board-level and senior-level management on cybersecurity issues.
- Firms should conduct regular, comprehensive risk assessments of cybersecurity threats they face, including external and internal threats and asset vulnerabilities.
- Firms should use technical controls to protect firm software and hardware based on the circumstances of the firm. Controls may include identity and access management, data encryption, and penetration testing.
- Firms should develop, implement, and test incident response plans, and assign staff roles and responsibilities for responding to cybersecurity incidents.
- Firms should incorporate strong due diligence procedures throughout the lifecycle of relationships with vendors who access sensitive firm or client information.
- Firms should train staff to reduce the probability of cyberattacks, using information from the firm's loss incidents, risk assessment process and threat intelligence gathering.
- Firms should collaborate through intelligence-sharing opportunities to protect the industry from cyber threats.
- Firms should evaluate cyber insurance to manage the risks associated with cybersecurity threats, and periodically review the scope and terms of this coverage. Importantly, the policy should cover the specific types of risk that may be exposed within the firm. Firms without coverage should evaluate the cost and benefits of available coverage options to manage the financial impact of potential cybersecurity events.

The OCIE Risk Alert is available at www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf

The FINRA Report is available at www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p602363.pdf

OCIE Releases 2015 Examination Priorities

On January 13, 2015, OCIE announced that its examination priorities for 2015 will focus on three thematic areas: protecting retail investors; assessing market-wide risks; and the use of data analytics to identify illegal activities.

The staff noted that retail investors are being offered an increasingly complex and evolving set of investment options, including products and services that were previously considered "alternative" or "institutional." As a result of this trend, the staff identified the following examination initiatives, among others, for 2015:

- *Alternative Funds*. The staff will assess funds offering alternative investments and using alternative investment strategies, including: (1) their leverage, liquidity, and valuation policies and procedures; (2) factors relevant to the adequacy of the funds' internal controls; and (3) the manner in which such funds are marketed.
- *Fixed Income Funds*. The staff will continue to monitor whether funds with significant exposure to interest rate increases have implemented compliance policies and procedures and controls sufficient to ensure that fund disclosures are not misleading and are consistent with fund investment and liquidity profiles.
- *Fee Selection and Reverse Churning*. The staff noted that financial professionals are increasingly operating as investment advisers or as dually registered investment advisers/broker-dealers, rather than solely as broker-dealers, which often leads to a variety of available fee structures. Where an adviser has multiple fee arrangements, the staff will focus on recommendations of account types at the inception of the arrangement and thereafter, including fees charged, services provided and applicable disclosure about such relationships.
- *Sales Practices*. The staff will assess whether advisers are using improper or misleading practices when recommending the movement of retirement assets from employer-sponsored defined contribution plans into other investments and accounts, with a focus on those recommendations that pose greater risks and/or will result in higher fees.

The staff also announced certain market-wide risk initiatives that will examine structural risks and trends involving multiple firms or entire industries, including the following:

- *Cybersecurity*. The staff will continue its efforts to examine broker-dealers' and investment advisers' cybersecurity compliance and controls and will expand the initiative to include transfer agents.
- *Large Firm Monitoring*. The staff will continue to monitor the largest U.S. broker-dealers and advisers with the objective of assessing risks at individual firms and maintaining early awareness of industry-wide developments.
- *Clearing Agencies*. The staff will continue to employ a risk-based approach while conducting annual examinations of all clearing agencies designated systemically important.

The staff noted that OCIE has made significant enhancements to its data analytic capabilities over the last few years that enable more efficient and effective analysis on firms that are potentially engaged in fraudulent and/or illegal activity. The staff will use its data analytic capabilities for the following initiatives, among others, in 2015:

- *Excessive Trading*. The staff will continue to analyze data obtained from clearing brokers to identify and examine introducing brokers and registered representatives that appear to be engaged in excessive trading.
- *Anti-Money Laundering*. The staff will use its analytic capabilities to continue to examine clearing and introducing broker-dealers' AML programs, focusing on firms that did not file (or filed late/incomplete) suspicious activity reports and programs that allow customers to deposit and withdraw cash and/or provide customers direct access to the markets from higher-risk jurisdictions.

In addition to the thematic areas of focus above, the staff also announced the following 2015 examination priorities:

- *Never-Before Examined Investment Companies*. The staff will conduct focused, risk-based examinations of registered investment companies that have not yet been examined.
- *Proxy Services*. The staff will examine how select proxy advisory service firms make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest, as well as how investment advisers comply with their fiduciary duty in voting proxies on behalf of investors.

For a complete list of 2015 Examination Priorities, see www.sec.gov/about/offices/ocie/national-examination-program-priorities-2015.pdf.

ICI and IDC Issue White Paper on Funds' Use of Proxy Advisory Firms

In January 2015, the ICI and IDC issued a paper, "Report on Funds' Use of Proxy Advisory Firms," to assist boards and advisers in understanding and fulfilling their responsibilities with respect to proxy voting and the use of proxy advisory firms. The paper provides an overview of proxy advisory firm services, board oversight of proxy advisory firms, adviser due diligence and oversight of proxy advisory firms, and other miscellaneous considerations related to the use of proxy advisory firms. The paper recognizes that funds and advisers receive different types and levels of services from proxy advisory firms, that there is no single set of best practices for oversight of proxy advisory firms, practices continue to evolve, and that oversight of proxy advisory firms should be developed in a manner that complements the structure and practices of the board and adviser where relevant.

Proxy Advisory Firm Services

According to the paper, there are a wide range of services provided by proxy advisory firms that advisers may find useful in carrying out their proxy voting responsibilities. These services include: (1) assisting with the administrative tasks associated with proxy voting, such as keeping track of meeting dates and voting instructions, executing proxies in accordance with clients' instructions, generating voting reports, providing coverage and translation services with respect to foreign issuers, and compiling information for funds' annual proxy voting filings with the SEC on Form N-PX; (2) analyzing, providing research, and making voting recommendations, which advisers may take into account when deciding how to vote; (3) providing research and commentary on trends in prior and upcoming proxy seasons; (4) assisting with the formulation of and amendments to proxy voting guidelines; and (5) helping advisers mitigate conflicts of interest in voting proxies.

Board Oversight of Proxy Advisory Firms

As stated in the paper, a board typically delegates to the adviser the day-to-day oversight of the proxy advisory firm and the board may rely on the adviser to report to the board on the proxy advisory firm's performance. The paper notes that the topics addressed in board reports as well as their frequency vary and generally depend on the level and types of services provided. According to the paper, topics for inclusion in board reports might include: (1) a list or types of services offered by the proxy advisory firm and those services being used by the adviser; (2) the adviser's processes for overseeing the proxy advisory firm, including the type of information the adviser receives; (3) the adviser's assessment of the proxy advisory firm's capacity and competency to assist the adviser with proxy voting functions on behalf of the fund; (4) any material changes or events regarding the proxy advisory firm; and (5) updates of other pertinent information, such as the proxy advisory firm's guidelines and how the adviser uses the firm. The paper also notes that, in some situations, proxy advisory firms may make presentations at board meetings to educate the board about their services.

Adviser Due Diligence and Adviser Oversight of Proxy Advisory Firms

As the paper discusses, an adviser's oversight of proxy advisory firms is broadly similar to its oversight of any other service provider it may hire to assist it in carrying out a function that it has undertaken to perform. The paper notes that the adviser's oversight program and the adviser's due diligence efforts thereunder should be documented, will depend on the particular services provided and as an overarching principle, when selecting a proxy advisory firm, the adviser should consider the firm's capacity and competency to assist as well as the anticipated costs and benefits. The paper stresses that the adviser may wish to consider or evaluate additional factors as part of an initial due diligence review based on the services to be provided. The paper notes that, after an adviser has completed its initial due diligence and hired the proxy advisory firm, the adviser should continue to exercise ongoing oversight, which should occur no less frequently than the annual review of the adviser's own proxy voting policies and procedures. The paper recognizes that the adviser may choose any number of methods to keep apprised of significant developments affecting its business relationship with the proxy advisory firm, such as using recurring reviews, information requests or communications with the firm.

The paper also stresses that the adviser, subject to board approval, may want to formulate and maintain proxy voting guidelines in order to help ensure consistency and protect against potential conflicts of interest, and noted that, in many cases, the adviser adopts the proxy voting firm's standard guidelines. The paper notes that, irrespective of a proxy advisory firm's involvement, the proxy voting guidelines should reflect the adviser's and board's views about how to act in the best interest of the fund and that the adviser and board should review the guidelines at least annually. The paper recognizes that proxy voting guidelines alone, no matter how detailed, will not always yield obvious voting decisions and that with these case-by-case evaluations, many fund advisers use proxy advisory firms' research and recommendations as one resource. The paper notes that an adviser may wish to assess a proxy advisory firm's research capabilities and voting recommendations and may also want to evaluate potential conflicts of interest to which a proxy advisory firm may be subject, with these evaluations being undertaken at least annually. The paper stresses that an adviser should always consider whether the proxy advisory firm can make recommendations that are in the best interest of the fund.

The ICI/IDC paper is available at www.ici.org/pdf/pub_15_proxy_advisory_firms.pdf.

Litigation and Enforcement Actions

U.S. Court of Appeals Reinstates Shareholder Class Action against Schwab Alleging Various Claims Relating to Violation of Fundamental Investment Policies

On March 9, 2015, the U.S. Court of Appeals for the Ninth Circuit made a number of significant holdings in a case involving a mutual fund advised by Charles Schwab Investment Management, Inc. (CSIM). The following is a summary of the litigation to date, including the recent findings by the Ninth Circuit:

In August 2008, Northstar Financial Advisors, Inc., on behalf of its clients, filed a shareholder class action lawsuit against Schwab Investments, a Massachusetts business trust, the board of trustees of Schwab Investments and CSIM, setting forth a number of claims based on allegations that the Schwab Total Return Bond Fund, a series of Schwab Investments for which CSIM serves as investment adviser, deviated from its fundamental investment policies. Specifically, between September 2007 and February 2009, the Fund is alleged to have: (1) deviated from its fundamental investment objective to track the Lehman Brothers U.S. Aggregate Bond Index, the Fund's benchmark, by investing in non-U.S. agency collateralized mortgage obligations that were not included in the Index; and (2) invested in non-agency mortgage-backed securities and collateralized mortgage obligations in excess of fundamental investment policies prohibiting the Fund from investing more than 25% of its total assets in any industry and investing more than 25% of its total assets in U.S. agency and non-agency mortgage-backed securities and CMOs. As a result of these investments, the Fund significantly underperformed its benchmark during the relevant period.

The plaintiffs' initial complaint asserted a number of claims relating to this activity, including: a violation of Section 13(a) of the 1940 Act, which prohibits a fund from, among other things, deviating from a fundamental investment policy without shareholder approval; a breach of fiduciary duty by the Fund's board of trustees relating to a denial of voting rights; a breach of a purported contract between Fund shareholders and Schwab Investments created when shareholders voted in 1997 to change the Fund's fundamental investment policies to those alleged to have been violated; and a breach of the implied covenant of good faith and fair dealing.

The defendants initially moved to dismiss the suit, claiming that Northstar, the lead plaintiff, had no standing to sue because it never itself invested in the Fund, and that there is no private right of action under Section 13(a). The U.S. District Court for the Northern District of California agreed that Northstar had no standing to sue but allowed a shareholder's claim to be assigned to Northstar to cure the deficiency. While the District Court initially ruled against the defendants on the Section 13(a) claim, the defendants ultimately prevailed on appeal, where the U.S. Court of Appeals for the Ninth Circuit determined that there was no private right of action under that section.

In September 2010, the plaintiffs amended their complaint to remove the Section 13(a) claim and add a claim for breach of the investment advisory contract between Schwab Investments and CSIM, which required CSIM to manage the Fund in accordance with the Fund's fundamental investment objectives and policies, on a theory that plaintiffs were third-party beneficiaries of the contract.

The defendants again moved to dismiss the suit, arguing that all of the plaintiffs' claims should be precluded by the Securities Litigation Uniform Standards Act (SLUSA), which prohibits class actions brought by more than 50 plaintiffs if the action is based on state law claims and alleges either a material misrepresentation or omission or the use of manipulation or deception in connection with the purchase or sale of a security. On this point, the District Court agreed that all of the plaintiffs' claims, with the exception of the fiduciary duty claim to the extent it was based purely on Massachusetts law, should be precluded by SLUSA because such claims all related essentially to misrepresentations by the defendants, in the Fund's prospectuses and other documents, relating to how the Fund would be managed. The District Court granted the defendants' motion to dismiss the breach of contract and implied covenant of good faith and fair dealing claims, determining that the plaintiffs had failed to show that the 1997 proxy vote created a contract between Schwab Investments and Fund shareholders. The District Court also determined that the harm from the purported breach of fiduciary duty affected all shareholders equally and therefore was properly viewed as being inflicted on the Fund; accordingly, the District Court determined that the claim must be brought in a derivative suit rather than individually by Fund shareholders. The District Court granted the plaintiffs leave to amend their complaint to re-assert the fiduciary duty claim in a manner so as not to be derivative or to implicate SLUSA. Finally, while the District Court was not fully persuaded by the defendants' arguments that Fund shareholders were not third-party beneficiaries of the investment advisory contract, the District Court noted that this claim, as previously presented, was precluded by SLUSA. The District Court granted the plaintiffs leave to amend their complaint to re-assert the third-party beneficiary claim in a manner that did not trigger SLUSA preclusion.

In March 2011, the plaintiffs filed another amended complaint, which contained revised breach of fiduciary duty claims against Schwab Investments' board of trustees and CSIM as well as updated breach of contract claims against CSIM under the third-party beneficiary theory.

The defendants again moved to dismiss all claims. The District Court was not persuaded by the plaintiffs' additional pleading on the fiduciary duty claims and dismissed with prejudice all of the claims, determining that such claims failed to allege a breach of duty owed directly to shareholders, and that these claims would need to be brought derivatively. The District Court also dismissed the third-party beneficiary claims with prejudice, having not been persuaded by additional pleading that shareholders should be considered third-party beneficiaries of an investment advisory contract under California law.

The plaintiffs thereafter appealed a number of the claims previously dismissed by the District Court, including the breach of contract claim relating to the 1997 proxy vote, the fiduciary duty claims and the third-party beneficiary claim relating to the Fund's investment advisory contract.

On March 9, 2015, the U.S. Court of Appeals for the Ninth Circuit reversed the prior dismissal of these claims and remanded the case for further deliberation. In reversing the prior dismissal of the breach of contract claim relating to the 1997 proxy vote, the Ninth Circuit concluded that "the mailing of the proxy statement and the adoption of the two fundamental investment policies after the shareholders voted to approve them, and the annual representations by the Fund that it would follow these policies are sufficient to form a contract between the shareholders on the one hand and [Schwab Investments] on the other." The Ninth Circuit concluded that the Fund offered investors the right to invest on the terms set forth in its proxy statement and prospectuses, that shareholders accepted the offer by so investing, that the investment or continued investment by shareholders was the consideration and that the parties' object was lawful, thereby satisfying the requirements for a contract.

The Ninth Circuit also vacated the prior dismissal of the plaintiffs' fiduciary duty claims, disagreeing with the District Court's determination that the plaintiffs "failed to successfully allege a breach of any duty owed directly to Fund investors." The Ninth Circuit pointed to the Fund's declaration of trust, which states that "the Trustees hereby declare that they will hold all cash, securities and other assets, which they may from time to time acquire as Trustees hereunder IN TRUST to manage and dispose of the same . . . for the pro rata benefit of the holders from time to time of Shares of the Trust." In addition, citing cases under Massachusetts law and various secondary sources, the Ninth Circuit determined that trustees of a Massachusetts business trust owe a fiduciary relationship to all trust shareholders, and that "there is no logical basis for the argument that the trustees of a mutual fund organized as a Massachusetts business trust owe a fiduciary duty to the trust, rather than the shareholders, and that for this reason they are limited to a derivative action on behalf of the trust." The Ninth Circuit further identified general differences between when a derivative action should be required in the case of an operating corporation, where share prices rise and fall as a by-product of business success and share price declines may result from either unsuccessful decisions or fiduciary misconduct, and in the case of a mutual fund, where there is no business other than investing and any decrease in share price flows directly and immediately to shareholders, which would especially be true when such a decrease results from the violation of a fundamental investment policy.

Finally, the Ninth Circuit reversed the decision below to dismiss the third-party beneficiary claim relating to the Fund's investment advisory contract, concluding that plaintiffs adequately alleged that the investment advisory contract was entered into with the intention to benefit Fund shareholders. Among other things, the Ninth Circuit cited as evidence that shareholders should be considered third-party beneficiaries of the investment advisory contract the requirement of the 1940 Act that investment advisory contracts be approved by fund shareholders.

The Ninth Circuit declined to address the effect of SLUSA on the various common law causes of action in the case and remanded the case to the District Court to determine the applicability of SLUSA to the plaintiffs' various claims.

SEC Settles Charges against Adviser for Failure to Maintain Fund Assets with Qualified Custodian and Other Compliance Violations

On February 12, 2015, the SEC announced that Water Island Capital LLC, an investment adviser to several alternative mutual funds, had agreed to pay a $50,000 penalty to settle SEC charges that it caused the funds it managed to violate Section 17(f) of the 1940 Act by failing to maintain certain fund assets with a qualified custodian. Specifically, the SEC order found that Water Island Capital failed to ensure that approximately $247 million in cash collateral related to fund derivative trades was maintained with the funds' custodial bank; instead, the cash collateral was held by broker-dealer counterparties.

The SEC also found that Water Island Capital failed to implement the funds' directed brokerage policies and procedures, which required the firm to create and maintain an approved list of executing brokers for the funds, as well as to monitor the funds' compliance with the directed brokerage policies and procedures. The SEC order stated that Water Island Capital failed to create the list and failed to maintain documentation reflecting monitoring of the funds' directed brokerage policies and procedures.

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