Investment Services Regulatory Update

May 1, 2015

In This Issue

New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Cybersecurity Guidance

Department of Labor Issues New Proposed Rule Defining Fiduciary Investment Advice

Division of Investment Management Releases Money Market Fund Reform FAQs

Division of Investment Management Publishes FAQs on Valuation Guidance

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

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

Other News

SEC Asset Management Unit Co-Chief Discusses Enforcement Priorities

SEC and FINRA Issue Results of Cybersecurity Examinations

Litigation and Enforcement Actions

U.S. Court of Appeals Rejects Defendants' Request for Rehearing in Schwab Case Relating to Violation of Fundamental Investment Policies

SEC Settles Charges Against Adviser and CCO for Providing Inaccurate and Incomplete Information to Fund Board in Connection with Contract Renewal

SEC Settles Conflict-of-Interest Case Against BlackRock and Former Chief Compliance Officer Concerning Portfolio Manager's Outside Business Activities

SEC Announces Fraud Charges Against Investment Adviser Accused of Concealing Poor Performance of Fund Assets from Investors

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

VEDDER PRICE®

New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Cybersecurity Guidance

On April 28, 2015, the staff of the Division of Investment Management of the SEC published a Guidance Update addressing cybersecurity risks and the need for funds and advisers to protect confidential and sensitive information concerning fund investors and advisory clients. The staff noted that cyber-attacks on a wide range of financial services firms highlight the need for firms to review their cybersecurity measures.

The staff remarked that funds and advisers should identify their respective compliance obligations under the federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyber-attacks. The staff identified a number of measures that funds and advisers may wish to consider in addressing cybersecurity risk, including the following to the extent they are relevant:

- Conduct a periodic assessment of: (1) the type, sensitivity and location of information that the firm collects, processes and/or maintains, and the technology systems it uses for such purposes; (2) internal and external cybersecurity threats and vulnerabilities of the firm's information and technology infrastructure; (3) security controls and processes currently in place; (4) the potential consequences of a breach in the firm's information or technology systems; and (5) the effectiveness of the governance structure for the management of cybersecurity risks.
- Create a cybersecurity strategy to mitigate, identify and respond to cybersecurity threats, including: "(1) controlling access to various systems and data via management of user credentials, authentication and authorization methods, firewalls and/or perimeter defenses, tiered access to sensitive information and network resources, network segregation and system hardening; (2) data encryption; (3) protecting against the loss or exfiltration of sensitive data by restricting the use of removable storage media and deploying software that monitors technology systems for unauthorized intrusions, the loss or exfiltration of sensitive data, or other unusual events; (4) data backup and retrieval; and (5) the development of an incident response plan."
- Implement the cybersecurity strategy by means of written policies and procedures and through training that enables officers and employees to appreciate applicable threats and understand the measures designed to prevent, identify and respond to such threats, and that monitor compliance with such policies and procedures.

The staff noted that because funds and advisers are varied in their operations, they should tailor their compliance programs based on the nature and scope of their businesses. Additionally, the staff noted that funds and advisers may also wish to consider assessing whether protective cybersecurity measures are in place at relevant service providers. The staff recognized that it is not possible for a fund or adviser to anticipate and prevent every cyber-attack, but that a fund's or adviser's appropriate planning to address cybersecurity and a rapid response capability may assist funds or advisers in mitigating the impact of any such attack, as well as complying with the federal securities laws.

The Guidance Update is available at www.sec.gov/investment/im-guidance-2015-02.pdf

Department of Labor Issues New Proposed Rule Defining Fiduciary Investment Advice

On April 14, 2015, the U.S. Department of Labor (DOL) released a re-proposed regulation defining who is considered a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act of 1975, as amended (ERISA) with respect to investment advice provided to a plan or its participants or beneficiaries. The proposal, which replaces a prior proposed regulation issued in 2010, also applies to the definition of a "fiduciary" of a plan (including an IRA) under the Internal Revenue Code of 1986 (the Code). If adopted, the proposal would treat persons who provide investment advice or recommendations to an employee benefit plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner as fiduciaries under ERISA and the Code in a broader scope of advice relationships than the existing ERISA and Code regulations. For instance, included among the proposed categories of fiduciary investment advice is a "recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA." In this regard, the DOL has stated that the current ERISA fiduciary standard, the product of a 1975 regulation, pre-dates the "existence of participant-directed 401(k) plans, widespread investments in IRAs and the now commonplace rollover of plan assets from fiduciary-protected plans to IRAs." Thus, as the DOL's notice of proposed rulemaking states, "many investment professionals, consultants and advisers are not required to adhere to ERISA's fiduciary standards or to the prohibited transaction rules" and "may operate with conflicts of interest that they need not disclose and have limited liability under federal pension law for any harms resulting from the advice they provide." The proposal also includes a number of specific carve-outs from the definition of investment advice, as well as new and amended prohibited transaction exemptions. Comments on the proposal are due by July 6, 2015.

The proposal is available at https://federalregister.gov/a/2015-08831

Division of Investment Management Releases Money Market Fund Reform FAQs

On April 22, 2015, the staff of the Division of Investment Management of the SEC released guidance in the form of 53 frequently asked questions relating to various interpretive issues arising from the release adopting money market fund rule amendments issued in July 2014 (the Adopting Release). Set forth below are certain of the notable issues addressed by the staff.

Funds that Invest only in Securities that Mature in 60 Days or Less

- A money market fund that is subject to a floating net asset value (NAV) may not state in its advertising, sales literature or prospectus that it will seek to maintain a stable NAV by limiting its portfolio securities to only those securities with a remaining maturity of 60 days or less and valuing those securities using amortized cost. Such a statement, in the staff's view, would be misleading or confusing to investors.

The staff explains that a floating NAV money market fund's share price may fluctuate in certain market conditions, regardless of how the fund seeks to limit its investment duration or its use of amortized cost for certain portfolio securities. Thus, as directed in the Adopting Release, all floating NAV money market funds must state in their advertisements, sales materials and prospectus that their share price will fluctuate.

The staff also cites the SEC's guidance in the Adopting Release as to the allowance for a floating NAV money market fund to use amortized cost to value individual portfolio securities under certain circumstances. The staff cautions that "if a disparity were to arise between the amortized price of a security that matures in 60 days or less and the fair value of such a security that was large enough that it would affect the fund's NAV, then the staff believes that the use of amortized cost in that situation would not be compatible with the guidance provided in the Adopting Release" since the amortized cost value of the portfolio security would not be "approximately the same" as the fair value of the security determined without the use of amortized cost valuation.

Retail Money Market Funds

- An estate of a natural person qualifies as a natural person for purposes of qualifying as a retail money market fund.

However, the staff also states that when the estate's money market fund shares are transferred to the ultimate beneficiaries, those ultimate beneficiaries must be natural persons if they are to remain invested in the retail money market fund.

- Life insurance separate account contract owners qualify as natural persons.

Consistent with the SEC's look-through approach for determination of beneficial ownership, a retail money market fund can look through life insurance separate accounts to the contract owners for purposes of natural person eligibility. However, insurance company funds-of-funds do not qualify as natural persons. Retail money market funds must have policies and procedures in place that address how they may look through to the beneficial owners.

- A retail money market fund may have non-natural person affiliates that beneficially own shares of the fund in order to facilitate fund operations (e.g., providing initial seed capital or financial support).

The staff states that it would not object so long as the investments are solely intended to facilitate fund administration and operations. The determination as to whether an investment is solely intended to facilitate fund administration and operations would depend on the particular facts and circumstances of each separate investment.

- The staff would not object if a retail money market fund involuntarily redeemed investors who no longer met the disclosed eligibility requirements of the fund, even outside the context of the exemptive relief provided by the SEC in the Adopting Release for involuntary redemptions as part of a one-time reorganization.

Retail money market funds may involuntarily redeem ineligible investors subject to 60 days' prior written notice; however, an ineligible investor may not have his or her shares automatically reinvested into shares of another money market fund, as that fund's investment policies may not be consistent with those of the current investment.

Fees and Gates

- If a shareholder of a money market fund submits a redemption order while a gate is in effect, that shareholder must submit a new redemption order after the gate is lifted for the order to be effective.

The staff states that while redemptions are suspended, the fund and its agents may not accept redemption orders.

- A fund should implement a fee or gate immediately after the board's determination to impose one.

The staff recognized that it may take some time to notify shareholders and intermediaries that a fee or gate is in place and that the transfer agent and intermediaries may need some time to implement the fee or gate. The staff notes that directors will need to consider whether it would be consistent with their fiduciary duty to allow for a material lapse of time between their determination and the implementation of the fee or gate.

- If a liquidity fee is imposed intraday, an intermediary that receives both purchase and redemption orders from a single underlying accountholder may apply the liquidity fee to the net amount of redemptions made by that same accountholder, even if the purchase order was received before the time the liquidity fee was implemented.

The staff states that intermediaries may choose to collect a liquidity fee on a shareholder's net redemption amounts, even if orders for some purchases netted against the redemptions were received prior to the time the liquidity fee went into effect.

- If a redemption request was verifiably submitted to the fund's agent before a gate or fee is imposed, but is received by a money market fund (or its agent) *after* such an action is taken, the fund may pay the proceeds of the redemption request despite the gate or, similarly, not impose a liquidity fee on the redemption associated with the payment.

The staff states that it would not object if the fund can verify that the order was submitted to the fund's agent before the suspension of redemptions or imposition of the liquidity fee.

Government Money Market Funds

- A "government security" does not have to be backed by the full faith and credit of the U.S. government.

The Adopting Release requires government money market funds to hold at least 99.5% of their portfolios in government securities. The staff's guidance confirms that a "government security" may be issued or guaranteed by the United States or a person controlled or supervised by and acting as an instrumentality of the U.S. government. As a result, government agency securities, such as Fannie Mae and Freddie Mac securities, which are issued but not guaranteed by the U.S. government, qualify as "government securities." In addition, the New York Federal Reserve Bank, which issues overnight reverse repurchase agreements, may be considered an instrumentality of the U.S. government and thus its repos satisfy the definition of "government security." Trade receivables arising from the sale of government securities also qualify as "government securities."

- Bank certificates of deposit, which are insured up to the $250,000 FDIC insurance limit, are *not* "government securities" for purposes of the definition of a government money market fund.

The staff has previously declined to provide no-action assurance that FDIC-insured bank certificates of deposit are "government securities" within the meaning of Section 2(a)(16) of the 1940 Act.

- A fund should test that it meets the definition of a "government money market fund" each time it acquires a portfolio security.

The staff confirmed that the time of acquisition of a security is the point at which the 99.5% government securities investment minimum is tested. Accordingly, a sale of securities that results in a government money market fund falling below the 99.5% threshold will not disqualify the fund as a "government

money market fund," but such a fund may not purchase additional non-qualifying securities until it has reached the 99.5% minimum threshold.

- A money market fund that relies on the retail exception to maintain a stable NAV cannot invest at least 80% of its total assets in government securities, but less than 99.5%, and call itself a "government money market fund."

The money market fund reform FAQs, which the staff noted it expects to update from time to time, are available at www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked-questions.shtml

Division of Investment Management Publishes FAQs on Valuation Guidance Included in the 2014 Release Adopting Money Market Fund Reforms

On April 23, 2015, the staff of the Division of Investment Management of the SEC issued "Valuation Guidance Frequently Asked Questions," addressing the guidance applicable to all funds that appeared in the release adopting money market fund rule amendments issued in July 2014 (the Adopting Release). In the Adopting Release, the SEC reminded fund directors that they have a non-delegable statutory duty to determine the fair value of portfolio securities when market prices are not readily available, but reaffirmed that directors may appoint others, such as the fund's investment adviser or a valuation committee, to assist them in the determination of fair value, and to make the actual calculations pursuant to fair value methodologies approved by the directors.

The first Q&A states the staff's belief that the guidance provided in the Adopting Release was "not intended to change the general nature of the board's responsibility to oversee the process of determining whether an evaluated price provided by a pricing service, or some other price, constitutes a fair value for a fund's portfolio security or limit a board's ability to appropriately appoint others to assist in its duties." The staff cites the discussion in the Adopting Release as to a board's decision to use evaluated prices from a pricing service, noting the SEC's recommendation that a fund's board "may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change…[and] assess, among other things, the quality of the evaluated prices provided by the service and the extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its NAV." Notwithstanding the non-delegable fair valuation responsibility of the board, the staff states its belief that, "subject to adequate oversight," a fund's board may delegate specific responsibilities with respect to implementing the fund's valuation policies and procedures, such as its due diligence review of pricing services (including the considerations recommended in the Adopting Release). The board must still be able to satisfy itself that all appropriate factors have been considered that are relevant to the fair value of the fund's portfolio securities and to the methodology employed in determining the fair value of those securities.

The second Q&A states the staff's belief that funds using amortized cost to value their portfolio securities do not need to calculate their shadow prices daily; however, the staff takes the position that a fund should have policies and procedures in place to allow the fund to reasonably conclude that a portfolio security's amortized cost (when used) is approximately the same as the security's fair value using market-based factors. A fund's procedures could include a description of the market-based factors it considers in making a fair value determination (e.g., existing credit, interest rate, liquidity, and issuer-specific conditions), as well as how such factors are reviewed and monitored for each valuation determination.

The valuation guidance FAQs, which the staff noted it expects to update from time to time, are available at www.sec.gov/divisions/investment/guidance/valuation-guidance-frequently-asked-questions.shtml

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.

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, 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 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.
- 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

Litigation and Enforcement Actions

U.S. Court of Appeals Rejects Defendants' Request for Rehearing in Schwab Case Relating to Violation of Fundamental Investment Policies

On March 25, 2015, the U.S. Court of Appeals for the Ninth Circuit issued a decision reinstating several claims in the shareholder class action litigation originally brought in August 2008 by Northstar Financial Advisors, Inc., on behalf of its clients, against Schwab Investments, a Massachusetts business trust, the board of trustees of Schwab Investments and Charles Schwab Investment Management, Inc. (CSIM). The plaintiffs' claims relate to allegations that the Schwab Total Return Bond Fund, a series of Schwab Investments for which CSIM serves as investment adviser, invested in non-agency mortgage-backed securities and collateralized mortgage obligations in violation of its fundamental investment policies between September 2007 and February 2009, causing the fund to significantly underperform its benchmark during that period. Following the issuance of the Ninth Circuit's opinion in March, the defendants immediately petitioned for a rehearing.

On April 28, 2015, in a two-to-one decision, a three-judge panel of the Ninth Circuit rejected the defendants' petition for a rehearing. The order rejecting the petition stated that no further petitions for a rehearing may be filed. Here 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. As noted, following the issuance of the Ninth Circuit's opinion in March, the defendants immediately petitioned for a rehearing.

On April 2, 2015, the Investment Company Institute (ICI) and the Independent Directors Council (IDC) filed an *amicus curiae* brief with the Ninth Circuit supporting the defendants' petition for a rehearing. In their brief, the ICI and the IDC noted the "profound impact on mutual funds and their boards and shareholders" of the Ninth Circuit's decision and that the decision "departs from long-standing law governing mutual funds and creates confusion and uncertainty nationwide."

In their brief, the ICI and the IDC raised a number of legal arguments for why the Ninth Circuit's decision was incorrect. Among other things, the ICI and the IDC argued that the Ninth Circuit misinterpreted Massachusetts law both by holding that an injury to a fund organized as a Massachusetts business trust gives rise to a direct rather than a derivative claim and by holding that the board of a fund organized as a Massachusetts business trust owes fiduciary duties directly to fund shareholders in addition to the fiduciary duties owed to the fund. In addition, the ICI and the IDC argued that the Ninth Circuit's holding that a fund prospectus creates an enforceable contract between shareholders and the fund "completely

up-ends the carefully crafted framework for regulating and enforcing the federal securities laws." The ICI and the IDC argued that a fund's prospectus is not a contract but rather a disclosure document, whose content is dictated by SEC regulation and variable with updates required at least annually and more frequently in the event of a material change, and that the Ninth Circuit's decision effectively created a new private right of action under the federal securities laws.

As noted above, the petition for a rehearing was denied on April 28, 2015.

SEC Settles Charges Against Adviser and CCO for Providing Inaccurate and Incomplete Expense Allocation Methodology and Profitability Information to Fund Board in Connection with Contract Renewal

On April 21, 2015, the SEC announced settled administrative proceedings against Kornitzer Capital Management, Inc. (KCM), the adviser to the Buffalo Funds, and Barry E. Koster, KCM's chief financial officer and chief compliance officer, based on the SEC's finding that KCM and Koster violated Section 15(c) of the 1940 Act by providing inaccurate and incomplete information concerning the profitability of KCM's advisory contracts with the Funds. The SEC found that KCM violated its duty under Section 15(c) to furnish such information as may reasonably be necessary for investment company directors to evaluate the terms of the advisory contracts and that Koster caused such violation.

The SEC found that the profitability analyses prepared and provided by Koster on behalf of KCM included an explanation of KCM's expense allocation methodology which specifically represented that employee compensation expense allocated to the funds was allocated "based on estimated labor hours." The SEC found that Koster in fact considered other undisclosed factors and adjusted the allocation of the compensation of the firm's CEO to the funds in a manner designed, in part, to achieve year-to-year consistency of KCM's profitability with respect to the funds. As a result, the firm was able to report almost identical pre-tax net profit margins year over year.

Although recognizing that Section 15(c) does not define what is "reasonably necessary" to evaluate the terms of an advisory contract, the SEC's order noted the 2004 form amendments and the disclosure necessary in the fund's shareholder report as to the approval or renewal of an advisory contract, as well as the required discussion therein concerning, among other things, the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund. Citing the 2004 adopting release, Disclosure Regarding the Approval of Investment Advisory Contracts by Directors of Investment Companies, the order states "[i]t would be difficult for a board to reach a final conclusion as to whether to approve an advisory contract without reaching conclusions as to each material factor." Thus, the SEC found that KCM's profitability analysis was reasonably necessary for the board's consideration of KCM's advisory contracts under Section 15(c) of the 1940 Act. KCM and Koster were ordered to pay penalties of $50,000 and $25,000, respectively.

SEC Settles Conflict-of-Interest Case Against BlackRock and Former Chief Compliance Officer Concerning Portfolio Manager's Outside Business Activities

On April 20, 2015, the SEC announced that it had reached a settlement with BlackRock Advisors LLC and BlackRock's former Chief Compliance Officer, Bartholomew A. Battista, relating to an undisclosed conflict of interest involving a BlackRock portfolio manager.

According to the SEC, Daniel J. Rice III, portfolio manager for various energy-focused funds and

separate accounts at BlackRock since 2005, formed Rice Energy, L.P. in 2007, a family-owned and-operated oil and gas company of which Mr. Rice was the general partner and in which he personally invested $50 million. The SEC order stated that in 2010, Rice Energy formed a joint venture with Alpha Natural Resources, Inc. (ANR), a publicly traded coal company whose common stock was held in the various funds and accounts Mr. Rice managed for BlackRock. The SEC stated that by mid-year 2011, ANR was the largest holding of the BlackRock Energy & Resources Portfolio, a registered fund managed by Mr. Rice. The SEC found that BlackRock knew and approved of Mr. Rice's involvement with Rice Energy and the joint venture with ANR but failed to disclose the conflict of interest to relevant BlackRock fund boards and advisory clients.

The SEC found that BlackRock willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any activity that operates as a fraud or deceit upon an advisory client, and that BlackRock breached its fiduciary duty to the relevant funds and advisory clients by failing to disclose the conflict of interest involving Mr. Rice's outside business activities to the funds' boards and advisory clients. The SEC also found that BlackRock failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, as required by Section 206(4) and Rule 206(4)-7, concerning the monitoring and assessment of employees' outside activities for conflicts of interest and the reporting of such conflicts of interest to fund boards and advisory clients. The SEC further found that Mr. Battista, the former CCO, caused these violations. Finally, the SEC found that BlackRock and Mr. Battista caused the relevant registered BlackRock funds to violate Rule 38a-1 under the 1940 Act as a result of Mr. Battista's failure to disclose the conflict of interest involving Mr. Rice to the funds' boards.

In settlement of these charges, BlackRock consented to the entry of an order finding that it committed the violations described above and agreed to pay a $12 million penalty. Mr. Battista also consented to the entry of an order finding that he caused the violations described above and agreed to pay a $60,000 penalty. Neither BlackRock nor Mr. Battista admitted or denied the charges.

This is the first instance in which the SEC has brought charges of violating Rule 38a-1 for failure to report a material compliance matter to a fund's board in accordance with the investment adviser's policies and procedures.

SEC Announces Fraud Charges Against Investment Adviser Accused of Concealing Poor Performance of Fund Assets from Investors

On March 30, 2015, the SEC announced fraud charges against Patriarch Partners, LLC, its CEO, Lynn Tilton, and its related entities, each a manager of certain collateralized loan obligation funds, for allegedly failing to value assets using the methodology described to investors in the offering documents of the funds. Such practices, the SEC alleges, resulted in the overpayment of management fees and other payments to the Patriarch entities of almost $200 million.

According to the SEC, the funds raised more than $2.5 billion in capital by issuing secured notes and used the proceeds to issue loans to distressed companies. The SEC states that despite the poor performance of many of these companies, the valuation of the loans remained unchanged. Contrary to the impairment categorizations called for in the fund documents, the SEC alleges that Ms. Tilton exercised subjective discretion over valuation levels, creating a major undisclosed conflict of interest and violation of her fiduciary duty to her clients.

Specifically, the SEC alleges that Ms. Tilton, who makes significant decisions relating to the management of each fund's collateral, has consistently and intentionally used her own discretion to determine how

an asset is categorized. Rather than determining loan impairment following the specific criteria outlined in the fund documents relating to the collection of interest and principal when due, the SEC alleges that Ms. Tilton maintained an asset's valuation category unless and until she decided that she would no longer "support" the portfolio company (i.e., she would cease to provide financial and managerial support). The SEC notes that certain portfolio companies have failed to pay as much as 90% of the interest owed to the funds, yet such loans remain in the highest valuation classification. In addition, the SEC alleges that the financial statements of the funds are false and misleading for failing to be prepared in accordance with U.S. GAAP, as the fund documents require and Ms. Tilton has certified. As a result of the foregoing, the SEC has charged Ms. Tilton and the Patriarch entities with various counts of fraud under the Advisers Act and breach of her fiduciary duties to her clients.

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.

Investment Services Group Members

Chicago

David A. Sturms, *Chair* ...... +1 (312) 609 7589
Juan M. Arciniegas .... +1 (312) 609 7655
James A. Arpaia .... +1 (312) 609 7618
Deborah B. Eades .... +1 (312) 609 7661
Karin J. Flynn .... +1 (312) 609 7805
Renee M. Hardt .... +1 (312) 609 7616
Joseph M. Mannon........... +1 (312) 609 7883
John S. Marten, *Editor* ...... +1 (312) 609 7753
Maureen A. Miller .... +1 (312) 609 7699
Robert J. Moran................ +1 (312) 609 7517
Cathy G. O'Kelly................ +1 (312) 609 7657
Junaid A. Zubairi............... +1 (312) 609 7720
Heidemarie Gregoriev .... +1 (312) 609 7817
Matthew A. Brunmeier ...... +1 (312) 609 7506
Megan J. Claucherty .... +1 (312) 609 7863
Jennifer M. Goodman........ +1 (312) 609 7732
Ellen Yiadom Hoover .... +1 (312) 609 7707
Nicole M. Kuchera .... +1 (312) 609 7763
Travis N. Moyer................. +1 (312) 609 7739
Nathaniel Segal, *Editor* ..... +1 (312) 609 7747
Jacob C. Tiedt .... +1 (312) 609 7697
Cody J. Vitello................... +1 (312) 609 7816

New York

Joel S. Forman .... +1 (212) 407 7775

Washington, DC

Bruce A. Rosenblum.......... +1 (202) 312 3379

London

Richard Thomas .... +44 (0)20 3667 2930
Sam Tyfield .... +44 (0)20 3667 2940

VEDDER PRICE

Investment Services Group

With deep experience in all matters related to design, organization and distribution of investment products, Vedder Price can assist with all aspects of investment company and investment adviser securities regulations, compliance matters, derivatives and financial product matters, and ERISA and tax matters. Our highly experienced team has deep knowledge in structural, operational and regulatory matters, coupled with a dedication to quality, responsive service.

This Regulatory Update is only a summary of recent information and should not be construed as legal advice.

This communication is published periodically by the law firm of Vedder Price. It is intended to keep our clients and other interested parties generally informed about developments in this area of law. It is not a substitute for professional advice. For purposes of the New York State Bar Rules, this communication may be considered ATTORNEY ADVERTISING. Prior results do not guarantee a similar outcome.

Vedder Price P.C. is affiliated with Vedder Price LLP, which operates in England and Wales, and with Vedder Price (CA), LLP, which operates in California.

© 2015 Vedder Price. Reproduction of this content is permitted only with credit to Vedder Price.