Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Guidance on Personal Trade Reporting of Accounts Over Which Access Persons Have No Influence or Control

On June 26, 2015, the staff of the Division of Investment Management of the SEC issued a Guidance Update addressing the staff's views on the application of the exception from personal securities and trading reporting under an adviser's code of ethics for its directors, officers, partners and other supervised persons with access to nonpublic information regarding securities transactions ("access persons") for securities held in an account over which the access person has "no direct or indirect influence or control" (the "reporting exception"). Specifically, the staff addressed the application of the reporting exception to an access person's trusts and third-party discretionary accounts. In this connection, the staff states that an access person may rely on the reporting exception with respect to a blind trust, in which a trustee manages funds for the benefit of such access person, who has no knowledge of the specific management actions taken by the trustee and no right to intervene in the trustee's management.

In the Guidance Update, the staff notes that some advisers have asserted that the reporting exception applies to (1) an access person's trusts when such person (i) is a grantor or beneficiary of a trust managed by a third-party trustee, and (ii) has limited involvement in trust affairs, and (2) an access person's personal account when a third-party manager has discretionary authority over the account. In this regard, the staff states its view that the fact that an access person provides a trustee with management authority over a trust for which he or she is grantor or beneficiary, or provides a third-party manager discretionary investment authority over his or her personal account, by itself, is insufficient for an adviser to reasonably believe that the access person had "no direct or indirect influence or control" for purposes of relying on the reporting exception. Although this would not, by itself, enable an adviser to rely on the reporting exception, the staff believes that the adviser may be able to implement additional controls to establish a reasonable belief regarding the absence of influence or control such that an access person could rely on the reporting exception. In the staff's view, such additional policies and procedures should be reasonably designed to determine whether the access person actually has direct or indirect influence or control over the trust or account, rather than whether the third-party manager has discretionary or non-discretionary investment authority. Advisers may consider, for example:

- obtaining information about a trustee or third-party manager's relationship to the access person (e.g., independent professional versus friend or relative; unaffiliated versus affiliated firm);
- periodically obtaining specific certifications by access persons and their trustees or discretionary third-party managers regarding the access persons' influence or control over trusts or accounts (e.g., "Did you suggest that the trustee or manager make any particular purchases or sales of securities for account X during time period Y?");
- providing access persons with the exact wording of the reporting exception and a clear definition of "no direct or indirect influence or control" that the adviser consistently applies to all access persons; and

- on a sample basis, requesting reports on holdings and/or transactions made in the trust or discretionary account to identify transactions that would have been prohibited pursuant to the adviser's code of ethics, absent reliance on the reporting exception.

The Guidance Update is available at: http://www.sec.gov/investment/im-guidance-2015-03.pdf

SEC Requests Public Comment on the Listing, Trading and Selling of Exchange-Traded Products

On June 12, 2015, the SEC issued a release (the "Release") seeking public comment relating to the listing and trading of exchange-traded products ("ETPs"), which include exchange-traded funds (including open-end funds and unit investment trusts, in each case registered under the 1940 Act), pooled investment vehicles (including commodity trusts and partnerships that are registered under the Securities Act but not the 1940 Act) and exchange-traded notes (senior debt instruments issued by a financial institution that pay a return based on the performance of a reference asset), and the sale of these products by broker-dealers. Unlike the SEC's previous requests for public comment, the Release focuses on a broader group of ETPs—not just 1940 Act-registered exchange-traded funds (the largest category of ETPs)—and the oversight of the products under the Exchange Act. Citing the "enormous growth" in the number, aggregate market capitalization and variety of ETPs, including the increasing scope and complexity of ETP investment strategies in recent years, the SEC solicited public comment on fifty-three specific multi-part requests, divided into the following categories:

- **Arbitrage and Market Pricing:** The SEC requested comment on all aspects of the ETP arbitrage mechanism, including the nature, extent and potential causes of premiums and discounts across the ETP spectrum. Specifically, the Release sets forth eighteen multi-part requests for comment on the efficient and effective use of the ETP arbitrage mechanism. In the Release, the SEC noted its reliance upon ETP sponsor representations regarding the continued effectiveness and efficiency of arbitrage mechanisms when considering whether to grant exemptive relief under the Exchange Act. Issues identified for comment in this category include whether a listing exchange should have an obligation to monitor the effectiveness of an ETP's arbitrage mechanism on an ongoing basis and whether and how arbitrage mechanisms may affect trading in underlying or reference assets (including whether this varies by underlying asset type).
- **Exemptive and No-Action Relief under the Exchange Act:** Rules 101 and 102 of Regulation M under the Exchange Act generally prohibit distribution participants, issuers, selling security holders and their affiliated purchasers from purchasing, bidding for, or attempting to induce others to purchase or bid for covered securities during the restricted period of a distribution of securities. Because ETPs are in continuous distribution, they generally need, on an ongoing basis, to meet the conditions of the Regulation M relief that has been extended to them and to meet the representations made in seeking relief under Regulation M. The SEC requested comment on the application of Rules 101 and 102, noting the increased complexity of ETP investment strategies and the expanded types of underlying assets. Specifically, the SEC sets forth three multi-part requests for comment on approaches for preventing manipulation of ETP distributions by persons who may be incentivized to do so in light of the increasingly complex products and markets. The SEC also invites comment through four multi-part requests on existing conditions pertaining to ETP exemptive and no-action relief.

- **Exchange Listing Standards:** The SEC requested comment on the interplay between the national securities exchanges and the SEC in determining whether the proposed listing and trading of ETPs is consistent with the Exchange Act. The nine multi-part requests for comment generally relate to whether the SEC and the exchanges' independent obligations complement each other or overlap, and if they overlap, how the responsibilities should be more appropriately allocated.
- **Broker-Dealer Sales Practices and Investor Use of, and Understanding of, ETPs:** The Release also requests comment on the practices of broker-dealers in recommending or selling ETPs to retail investors. The fifteen multi-part requests for comment generally relate to how broker-dealers meet their obligations to customers and the extent to which investors' investment decisions are based on such broker-dealer recommendations. The Release also seeks comment on the extent to which individual investors understand the nature and operation of ETPs and on the ways ETPs are used by investors. For instance, the Release asks whether investors understand the arbitrage mechanisms of ETPs and whether there are aspects of such mechanisms that should be prominently disclosed to investors.

The Release was published in the Federal Register on June 17, 2015 and comments are due by August 17, 2015.

The Release is available at: https://www.federalregister.gov/articles/2015/06/17/2015-14890/request-for-comment-on-exchange-traded-products

SEC Proposes Rules to Modernize and Enhance Investment Company and Investment Adviser Reporting

On May 20, 2015, the SEC unanimously approved proposed rules, forms and amendments that are intended to modernize and enhance the reporting and disclosure of information by funds and investment advisers. The fund proposals are intended primarily to help the SEC and other market participants better assess the risks of different fund products. Funds would be required to provide information in a structured data format that would make it easier for the SEC and other market participants to analyze it. As to investment advisers, the proposed amendments to Form ADV seek to gather additional information for the SEC and the public to better understand the risk profile of individual investment advisers and the industry overall. Among other things, the proposed changes to reporting by investment advisers are intended to provide the SEC with information about separately managed accounts.

Proposed Rules for Funds

Form N-PORT and the Elimination of Form N-Q

The SEC proposed a new portfolio holdings report, Form N-PORT, which would be filed by all registered management investment companies (other than money market funds and small business investment companies) and unit investment trusts ("UITs") that operate as exchange-traded funds ("ETFs"). Reports would be filed with the SEC on a monthly basis, within 30 days after the close of each month, in a structured data format that facilitates collection and analysis of the data by the SEC. Proposed Form N-PORT would require funds to report information about the fund and its investments held as of the close of the preceding month, including several items of information not required under current rules.

Under the proposed Form, funds would be required to provide detailed information about individual investments, including data related to the pricing of securities, information regarding repurchase agreements and securities lending activities. In addition, Form N-PORT would significantly expand reporting obligations relating to derivatives and would require enhanced, standardized disclosure of each derivative contract, including the type of derivative (e.g., forward, future, option, etc.), the full name and Legal Entity Identifier (if any) of the counterparty and the terms and conditions of each derivative instrument. Form N-PORT also would require reporting of certain risk metric calculations that would measure a fund's exposure and sensitivity to changing market conditions, such as changes in asset prices, interest rates or credit spreads.

Although funds would be required to file Form N-PORT monthly, only information reported for the third month of each fund's fiscal quarter would be publicly available, and that information would not be made public until 60 days after the end of the fiscal quarter. The delayed public availability of data reported on Form N-PORT is intended to "deter front-running and other predatory practices, while still allowing the Commission to have a complete record of the portfolio for monitoring, analysis, and checking for compliance with Regulation S-X."

The SEC is also proposing to rescind Form N-Q, the current portfolio holdings report, because the data required by Form N-PORT would make it unnecessarily duplicative.

The expected compliance dates for the new Form N-PORT requirements are 18 months after the effective date of the new rules for funds with net assets of $1 billion or more, and 30 months after the effective date for smaller funds.

Amendments to Regulation S-X

The SEC is proposing amendments to Regulation S-X that would modify the presentation and content of fund financial statements which are included in shareholder reports and fund registration statements. The proposals would amend Regulation S-X to require standardized and enhanced disclosure regarding derivatives in a manner that is comparable to the information that would be required for reports on proposed Form N-PORT. In particular, the proposed rule amendments would require the presentation of standardized disclosure regarding fund holdings in various open futures, forwards and swap contracts, as well as for any written and purchased option contracts. The proposed rule amendments also would enhance the prominence of derivatives-related disclosures in a fund's financial statements, rather than permitting such information to be placed in the notes to the financial statements. In addition, the proposed rule amendments would require new disclosure in the notes to the financial statements relating to a fund's securities lending activities, including related amounts paid or received by the fund, the compensation terms of any lending agent, and the monthly average value of portfolio securities on loan.

The expected compliance date for the amendments to Regulation S-X is 8 months after the effective date of the proposed rule amendments.

Option for Website Transmission of Shareholder Reports

Proposed new Rule 30e-3 under the 1940 Act would provide funds with the option to fulfill periodic shareholder reporting requirements by making shareholder reports and quarterly portfolio holdings available on a website, subject to certain conditions regarding accessibility, shareholder consent and notice. (Currently, funds satisfy delivery requirements by printing and mailing shareholder reports, unless investors have affirmatively requested electronic delivery.)

Funds seeking to rely on Rule 30e-3 would be required to send notices to shareholders regarding the change to electronic delivery and online availability of shareholder reports on a regular basis, including instructions on how to continue to receive paper copies, free of charge.

Form N-CEN and Elimination of Form N-SAR

The SEC proposed a new annual reporting form, Form N-CEN, that would require funds to annually report certain census-type information to the SEC. Under the proposed rules, Form N-CEN would replace Form N-SAR, the form currently used to report fund census information. The new form would include many of the same reporting elements of Form N-SAR but would eliminate certain outdated and duplicative items. The new form would require funds to provide, among other changes, information on service providers, new disclosures relating to matters submitted to shareholders, as well as enhanced securities lending information.

Notably, Form N-CEN would require data related specifically to ETFs, including: (a) identifying information about the ETF's authorized participants (i.e., broker-dealers who have contractual arrangements with the ETF to purchase from or redeem to the ETF large blocks of shares known as creation units); (b) the number of ETF shares required to form a creation unit as of the last business day of the reporting period; and (c) the exchange on which the ETF is listed. In addition, Form N-CEN would require ETFs to report: (a) transactional fees (fixed and variable) applicable to the last creation unit purchased and the last creation unit redeemed during the reporting period; and (b) the total value (i) of creation units that were purchased by authorized participants primarily in exchange for portfolio securities on an in-kind basis, (ii) of those that were redeemed primarily on an in-kind basis, (iii) of those purchased by authorized participants primarily in exchange for cash, and (iv) of those that were redeemed primarily on a cash basis. Index funds (including ETFs which seek to track the performance of a specified index) would be required to report certain standard industry calculations, including tracking difference and tracking error.

According to the SEC, the form would streamline and update information reported to the agency to reflect current information needs. Reports would be filed annually within 60 days of the end of the fund's fiscal year, rather than semi-annually as is currently required by Form N-SAR for most funds. The expected compliance date for the new Form N-CEN requirements is 18 months after the effective date of the proposed rules.

Proposed Rules for Investment Advisers

Amendments to Form ADV

The SEC proposed several amendments to Form ADV that would require more detailed information regarding separately managed accounts ("SMAs") than the SEC currently collects, including information relating to the types of assets held in SMAs, the use of derivatives and borrowings in SMAs and the investment adviser's regulatory assets under management attributable to SMAs ("SMA RAUM"). For purposes of these proposed amendments, any accounts other than accounts of investment companies, business development companies and other pooled investment vehicles would be considered SMAs.

Under the proposed amendments to Form ADV, all investment advisers reporting that they have regulatory assets under management attributable to separately managed accounts would be required to report the approximate percentage of SMA RAUM invested in ten broad asset categories consistent with the asset categories contained in Form PF, such as exchange-traded equity securities, U.S. government/agency bonds, corporate bonds (investment grade and non-investment grade) and derivatives. The scope of certain additional SMA reporting would vary based on the SMA RAUM of the adviser, with certain requirements applicable only to those advisers that have SMA RAUM in excess of $150 million. Investment advisers also would be required to disclose the custodians that account for at least 10% of SMA RAUM.

In addition to SMA-related disclosure and other technical and clarifying amendments, the proposed amendments to Form ADV would add other questions to Part 1A of Form ADV to collect additional information regarding the adviser, its advisory business and affiliations, including:

- Social media information (i.e., web addresses of the adviser's social media accounts, such as Twitter, LinkedIn and Facebook);
- Branch office operations information (i.e., total number of offices at which the adviser conducts investment advisory business and information regarding the 25 largest offices in terms of number of employees);
- Information on whether the adviser's chief compliance officer is compensated or employed by any other person and identifying information relating to such other person; and
- Percentage ownership of qualified clients (as defined by Advisers Act Rule 205-3) in each private fund reported on the adviser's Form ADV.

The SEC's proposals also would permit by rule certain filing arrangements for the registration of multiple private fund adviser entities operating as a single advisory business (known as an "umbrella registration") that are currently outlined in staff guidance, through proposed Schedule R to Form ADV.

Amendments to Advisers Act Rule 204-2 (Books and Records)

The SEC also proposed amendments to Rule 204-2 under the Advisers Act. The proposed amendments would require advisers to maintain records on the calculation of performance information distributed to any person, along with adding certain additional requirements on communications related to performance, rate of return of accounts and securities recommendations. Currently, Rule 204-2 generally requires maintenance of such records only on materials distributed to 10 or more persons.

Comments on the proposed rules are due by August 11, 2015. The SEC release relating to the fund proposals, "Investment Company Reporting Modernization," Investment Company Act Release No. 31610 (May 30, 2015), is available at: http://www.sec.gov/rules/proposed/2015/33-9776.pdf. The release relating to the investment adviser proposals, "Amendments to Form ADV and Investment Advisers Act Rules," Investment Advisers Act Release No. 4091 (May 20, 2015), is available at: http://www.sec.gov/rules/proposed/2015/ia-4091.pdf.

FINRA Issues Interpretive Letter on Related Performance Information

On May 12, 2015, the staff of the Financial Industry Regulatory Authority ("FINRA") issued an interpretive letter to Hartford Funds Distributors, LLC ("HFD") that allows mutual fund distributors to provide certain types of related performance information in fund sales literature to institutional investors and financial intermediaries, subject to certain conditions, without violating FINRA Rule 2210. For purposes of the letter, "related performance information" means actual performance of all separate or private accounts or funds that (i) have substantially similar investment policies, objectives and strategies, and (ii) are currently managed or were previously managed by the same adviser or sub-adviser that manages the fund that is the subject of an institutional communication.

FINRA has taken the position in the past that the presentation of related performance information in communications with the public may be inconsistent with the content standards of Rule 2210. In permitting the conditional use of related performance information in communications only to persons who qualify as "institutional investors" under FINRA Rule 2210(a)(4), the staff noted that such communications do not raise the same investor protection concerns as sales materials provided to retail investors. HFD pointed to the increase in requests from financial intermediaries for related performance information in seeking the interpretive guidance, noting that such intermediaries are seeking additional performance data in connection with their responsibilities to conduct due diligence for their customers. In this regard, HFD stated that related performance information allows financial intermediaries to better assess the capabilities of a fund's adviser, particularly in circumstances where the adviser has been managing assets in the same strategy as the fund and either the fund is new (i.e., has no track record) or the fund's performance record is shorter than that of the adviser's track record.

The conditions for the use of related performance information in institutional communications include, among other things, (i) disclosure of any material differences between the funds or accounts for which related performance information is provided and the fund that is the subject of the institutional communication, (ii) clear labeling as to the communication's institutional use only, and (iii) for a fund in existence for more than one year, its actual performance must be displayed more prominently than the related performance information.

The interpretive guidance takes effect immediately. A copy of the guidance is available at: https://www.finra.org/industry/interpretive-letters/may-12-2015-1200am

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: http://www.sec.gov/investment/im-guidance-2015-02.pdf

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: http://www.sec.gov/divisions/investment/guidance/valuation-guidance-frequently-asked-questions.shtml

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: http://www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked-questions.shtml

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 ("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

Litigation and Enforcement Actions

SEC Settles Charges Against Mutual Fund Board Members, Investment Adviser and Administrator in Connection with Advisory Contract Approval and Disclosure Process

On June 17, 2015, the SEC announced settled administrative proceedings against Commonwealth Capital Management, LLC (the "Adviser"), the investment adviser to several series ("funds") of two open-end management investment companies, one organized as a Delaware statutory trust ("World

Funds Trust" or the "Trust") and the other as a Maryland corporation ("World Funds, Inc." or the "Corporation"), and members of the board of trustees of the Trust (the "Trust Board" and the members individually, "Trustees"), involving the alleged failure to satisfy specific duties imposed upon them by Section 15(c) of the 1940 Act in connection with the advisory contract approval process. In the same action, the SEC alleged that Commonwealth Shareholder Services, Inc. (the "Administrator" and together with the Adviser, the "Affiliated Service Providers"), the funds' administrator and an affiliate of the Adviser, failed to include required disclosure concerning the 15(c) process in a shareholder report for a series of the Corporation, causing the Corporation to violate Section 30(e) of the 1940 Act and Rule 30e-1 thereunder. The principal of the Affiliated Service Providers (the "Principal"), who also served as an interested member of the Trust Board and of the board of directors of the Corporation (the "Corporation Board"), is alleged to have caused the Adviser's violations.

The Principal formed the Affiliated Service Providers and other related entities in order to offer small and mid-sized mutual funds "turnkey" fund services, including investment advisory, fund accounting, fund administration, transfer agent and distribution services. The Adviser did not make the day-to-day investment decisions for the funds; instead, it contracted out those services to an unaffiliated sub-adviser (a "Third-Party Sub-Adviser").

The SEC alleges that, with respect to the Trust, the Adviser and the Principal did not furnish, and the Trustees did not have, and consequently did not evaluate, all the information they requested as reasonably necessary to evaluate the approval of the contracts with the Adviser. As to the Corporation, the SEC alleges that certain 15(c) information provided by the Adviser and the Principal in response to the Board's request was inaccurate. In relevant part, the SEC's order summarizes the alleged 15(c) process failures as follows:

World Funds Trust

As part of the 15(c) process, the Trust Board, with the assistance of independent counsel and the Administrator, requested that the Adviser and the Principal submit comparative fee information along with a completed 15(c) questionnaire concerning, among other things, the *Gartenberg* factors. In response, the Administrator compiled various documents, questionnaire responses and other relevant materials; the Principal reviewed and certified the questionnaire responses on behalf of the Adviser. However, the SEC found no documentary evidence that the Adviser furnished information regarding the fees paid by comparable funds. Nevertheless, the Trustees approved the advisory contracts because, as the SEC alleges, the Trustees considered the proposed advisory fees to be within an appropriate range.

In addition, the Trustees requested various information to evaluate the nature and quality of services provided by the Adviser. The SEC found that the Adviser "provided only limited disclosures that left unclear which services it intended to provide versus those that would be provided by others." The SEC noted that the advisory and sub-advisory contracts described the Adviser's and Third-Party Sub-Adviser's proposed duties using nearly identical language, except that the Third-Party Sub-Adviser's duties were subject to the Adviser's supervision. The SEC alleges that after reviewing the Adviser's written responses to the 15(c) questionnaire, the Trustees did not ask for, and the Adviser did not provide, any materials to clarify what services the Adviser would perform in exchange for its proposed fee. The questionnaire did indicate, however, that the Adviser would conduct oversight of the Third-Party Sub-Adviser through quarterly and annual due diligence reviews and would track the funds' portfolios to ensure compliance with stated investment limitations, but the Adviser did not articulate which portfolio management compliance services it would perform itself, and the Trustees did not request additional materials to clarify the matter. Although during the relevant time period the funds did not pay any advisory fees as a result of a fee waiver provided for in an expense limitation agreement, and the Adviser reimbursed the majority of operating expenses incurred by such funds, the Trustees "were obligated to evaluate [the Adviser's] services as compared to the fees provided for in the advisory contracts." In view of the foregoing, the SEC found that the Trustees approved the Trust's advisory contracts without having all the information they requested as reasonably necessary to evaluate such contracts.

World Funds, Inc.

As part of the 15(c) process with respect to a series of the Corporation (the "Fund"), the Adviser used a standard industry database to provide fee information for share classes that were comparable in size and with a similar investment strategy as the relevant share class of the Fund. The Adviser did not edit the tables to remove share classes that were not directly comparable to the Fund (an actively managed fund), causing the chart to contain various inapt comparisons, such as share classes with different distribution fee structures, assets at the share-class level rather than the total-fund level, different types of funds (e.g., index-based ETFs) and funds with different fee structures altogether. The Adviser provided two additional charts to the Corporation Board to use to compare the Fund's expense ratio and advisory fee, but these charts "provided only limited information." For instance, two of the four funds in the expense ratio chart had vastly different 12b-1 fees than the Fund (1.00% v. 0.25%), and two of the four funds in the advisory fee chart combined administration and advisory fees (yet the Fund, with separate administration and advisory fees, still had the highest advisory fee). The SEC alleges that the following year's 15(c) review utilized charts with the same comparisons and, consequently, the same deficiencies.

The SEC's order identified other deficiencies in its findings pertaining to the Corporation Board's 15(c) process: To assess the Adviser's profitability, the independent directors of the Corporation Board requested "all reasonably available financial information," including two years of financial statements and the basis and methodology for allocating indirect costs, overhead and other costs to the Fund. In response, the Adviser provided an income statement for only one year and a profitability chart that estimated overhead and other expenses for the same year and neither provided a written description of its allocation methodology nor included a balance sheet. In responses to questions in the 15(c) questionnaire regarding the expense limitation agreement and economies of scale, including the appropriateness of any Fund breakpoints, the Adviser erroneously claimed that no fees had been waived and that the advisory contract included appropriate breakpoints (breakpoints that all parties believed to have been in place were omitted from the contract).

The Administrator

The SEC's order also claims that the Administrator, which was contractually responsible for preparing shareholder reports for the Fund, failed to include the discussion of the material factors and conclusions that formed the basis for the Directors' approval of the advisory contracts in the Fund's 2010 shareholder report, thus causing the Corporation to violate Section 30(e) of the 1940 Act and Rule 30e-1 thereunder.

Settlement: Trustees, Adviser, Administrator and Principal

Without admitting or denying the findings, each Trustee, the Adviser and the Principal consented to the order and agreed to cease and desist from committing any further violations of Section 15(c) and the Administrator agreed to cease and desist from committing any further violations of Section 30(e) or Rule 30e-1. Each of the Trustees agreed to pay a penalty of $3,250, while the Principal and the Affiliated Service Providers agreed to jointly and severally pay a $50,000 penalty.

The SEC's order instituting administrative and cease-and-desist proceedings is available at: http://www.sec.gov/litigation/admin/2015/ic-31678.pdf

U.S. Supreme Court Allows Plaintiffs in 401(k) Plan Case to Pursue Breach of Fiduciary Duty Claims Under Continuing Duty Theory

On May 18, 2015, the U.S. Supreme Court issued a decision reinstating breach of fiduciary duty claims brought under the Employee Retirement Income Security Act ("ERISA") by certain beneficiaries of the Edison International 401(k) Savings Plan (the "Plan") against Edison International and certain others that the courts below had determined were time barred under ERISA's six-year statute of limitations. In doing so, the Supreme Court established that the fiduciary duty under ERISA not only requires a 401(k) plan fiduciary to exercise due care in the initial selection of investment options for the plan, but also imposes a continuing duty on the fiduciary to monitor plan investments and remove imprudent ones.

In 2007, the plaintiffs filed a complaint in the U.S. District Court for the Central District of California alleging that the defendants breached their fiduciary duty under ERISA by, among other things, selecting the higher priced retail share classes of certain mutual funds to be offered through the Plan when lower priced share classes of the same funds were available. Three of the funds were added to the Plan in 1999; the other three were added in 2002.

With respect to the claims relating to the three funds added to the Plan in 2002, the District Court sided with the plaintiffs and found that the defendants had failed to act in accordance with ERISA's fiduciary standards by selecting higher priced share classes for the Plan when lower priced share classes were available. The District Court stated that the defendants offered no credible explanation for the decision to offer the more expensive share classes and simply failed to consider less expensive share classes.

However, the District Court granted the defendants' motion for summary judgment with respect to the claims relating to the three funds added to the Plan in 1999, concluding that the claims were untimely because they were filed more than six years after the funds were added to the Plan. Under ERISA, a breach of fiduciary duty claim must be filed no later than six years after "the date of the last action which constituted a part of the breach or violation" or "in the case of an omission the latest date on which the fiduciary could have cured the breach or violation." The plaintiffs were permitted to argue that their claims were in fact timely because the funds in question underwent significant changes during the six-year statute of limitations period that should have prompted the defendants to conduct a full due diligence review and convert the retail share classes to less expensive classes. After hearing this argument, the District Court concluded that the plaintiffs had failed to show that the circumstances of the three funds added in 1999 had changed sufficiently during the six-year statutory period to require a prudent fiduciary to conduct a full due diligence review and convert the shares to lower priced classes.

In 2013, the U.S. Court of Appeals for the Ninth Circuit upheld the District Court's decision. Following that decision, the plaintiffs filed a petition for certiorari with the Supreme Court requesting that the Supreme Court review the Ninth Circuit's decision. The Supreme Court granted the petition on October 2, 2014, and arguments were heard on February 24, 2015.

On May 18, 2015, the Supreme Court, in a unanimous decision, vacated the Ninth Circuit's decision to uphold the District Court's granting of the defendants' motion for summary judgment with respect to the claims relating to the three funds added to the Plan in 1999 and remanded the case for further proceedings with respect to those claims. In determining how to apply ERISA's six-year statute of limitations, the Supreme Court considered the proper question to be whether the last action that constituted a part of the alleged breach of fiduciary duty occurred within the relevant six-year period. ERISA requires that a fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." The Supreme Court noted that the fiduciary standard under ERISA is derived from the common law of trusts and that courts should look to trust law in interpreting the contours of the ERISA standard. In this regard, the Supreme Court stated that, "under trust law, a fiduciary normally has a continuing duty…to monitor investments and remove imprudent ones," which is a duty separate from the obligation to exercise prudence in the initial selection of investments. As such, the Supreme Court concluded that the Ninth Circuit erred in applying the six-year statute of limitations based solely on the initial selection of investment options for the Plan and on significant changes thereto without considering the defendants' continuing fiduciary obligation to review the appropriateness of investment options.

SEC Settles Charges Against Nationwide Life Insurance Company For Failing to Process Purchase and Redemption Orders In Compliance with the 1940 Act

On May 14, 2015, the SEC announced settled administrative proceedings against Nationwide Life Insurance Company ("Nationwide") based on the SEC's finding that Nationwide violated Rule 22c-1 under the 1940 Act by processing purchase and redemption orders for variable insurance contracts and underlying funds received before 4:00 p.m. using the next day's price as opposed to the current day's price. The SEC found that Nationwide intentionally delayed retrieving orders sent by mail until late in the afternoon and waited until after 4:00 p.m. to have the orders delivered to Nationwide's home office.

The SEC found that the Nationwide variable contract prospectuses generally stated that orders received at Nationwide's Columbus, Ohio home office before 4:00 p.m. would receive the current day's accumulation unit value ("AUV"), i.e., the measure of the contract owner's investment in a contract based on the net asset value ("NAV") of the underlying funds, as adjusted for contract charges. Nationwide's prospectuses also disclosed that orders received after 4:00 p.m. would receive the next day's AUV. Similarly, the prospectuses of the underlying funds disclosed the same 4:00 p.m. cut-off for determining whether an order was assigned the current day's NAV or the next day's NAV. Despite the foregoing disclosure, the SEC found that for over fifteen years, Nationwide implemented a mail retrieval system intended to avoid processing orders received before 4:00 p.m. at the current day's AUV. To do so, the SEC found that Nationwide directed the Post Office to separate its mail relating to the variable products business from other mail and hired a private courier to collect and deliver such variable products mail to Nationwide's home office after 4:00 p.m., even though the variable products mail was available prior to such time and Nationwide's private courier made several other trips to the Post Office each day to retrieve Nationwide's other mail (as directed by Nationwide). The SEC's findings noted that on occasion, Nationwide employees complained to Post Office staff when portions of the variable products mail were inadvertently mixed together with the other mail and, consequently, delivered to Nationwide's home office prior to 4:00 p.m. The SEC found that, after one such incident, Nationwide requested a meeting with the Post Office and emphasized that it needed "late delivery" of the variable products mail "due to regulations that require Nationwide to process any mail received by 4:00 p.m. the same day." As a result of the foregoing conduct, the SEC found that Nationwide willfully violated Rule 22c-1 under the 1940 Act and ordered Nationwide to cease and desist from committing or causing any such violations and any future violations of Rule 22c-1 and pay a civil money penalty of $8,000,000.

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.

The SEC staff stated, "This is the first SEC case to charge violations of Rule 38a-1 for failing to report a material compliance matter such as violations of the adviser's policies and procedures to a fund board."

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