Investment Services Regulatory Update

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SEC Issues No-Action Letter Permitting a Fund-of-Funds to Invest in Assets that May Not Be Deemed Securities

On June 29, 2015, the staff of the SEC issued a no-action letter to Grant Park Multi Alternative Strategies Fund, which operates as a fund-of-funds, stating that it would not recommend enforcement action under Sections 12(d)(1)(A) and (B) of the 1940 Act if the Fund invests in assets that might not be considered securities under the 1940 Act, in addition to shares of underlying funds.

Funds are limited in their ability to acquire securities of other funds by Section 12(d)(1)(A) of the 1940 Act, which provides that no registered investment company ("acquiring company") may acquire securities of another investment company ("acquired company") if such securities represent more than 3% of the acquired company's outstanding voting stock or more than 5% of the acquiring company's total assets, or if such securities, together with the securities of other investment companies, represent more than 10% of the acquiring company's total assets. Section 12(d)(1)(G) of the 1940 Act provides that Section 12(d)(1)(A) will not apply to securities of an acquired company purchased by an acquiring company if, among other things, (i) the acquiring company and the acquired company are part of the same group of investment companies ("affiliated funds"), and (ii) the acquiring company holds only securities of affiliated funds, government securities and short-term paper. Rule 12d1-2, in turn, broadens the scope of permissible investments for a fund-of-funds relying on Section 12(d)(1)(G), enabling it to invest, among other things, in any types of securities (as defined by the 1940 Act) that are consistent with its investment policies; however, certain types of derivatives and other assets, including real estate, futures contracts, and other financial instruments, may not fall within the 1940 Act's definition of "securities." Thus, the Grant Park Fund sought no-action assurance from the staff to have greater flexibility in meeting its investment objectives by investing in derivatives and other financial instruments that might not be securities as defined by the 1940 Act.

In granting the no-action relief, the staff referenced the amendments to Rule 12d1-2 proposed by the SEC in 2008, which were intended to permit, among other things, a fund-of-funds relying on Section 12(d)(1)(G) to invest in assets, such as real estate, futures contracts, and other financial instruments, that might not qualify as securities under the 1940 Act. The staff noted that the SEC had issued, and has continued to issue, exemptive orders providing the relief that would have been codified in the proposed Rule 12d1-2 amendments and that such greater flexibility to invest in assets that might not be securities under the 1940 Act does not appear to present any additional concerns that Section 12(d)(1)(G) was intended to address. In the incoming letter, the Grant Park Fund also argued that its request was consistent with the rationale behind these exemptive orders.

The No-Action Letter is available at:

http://www.sec.gov/divisions/investment/noaction/2015/northern-lights-fund-trust-063015.htm

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

Litigation and Enforcement Actions

U.S. District Court Denies Motion to Dismiss Excessive Fee Case Against SEI Investments

On July 13, 2015, the United States District Court for the Eastern District of Pennsylvania issued a decision on the defandants' motion to dismiss in the case of *Curd v. SEI Investments Management Corp.*, Civ. Action No. 13-7219. In 2013, plaintiffs Steven and Rebel Curd filed suit in the District Court on behalf of five mutual funds (the "Funds") managed by SEI Investments Management Corporation (the "Investment Adviser"), alleging that the Investment Adviser and SEI Investments Global Funds Services (the "Administrator"), the Funds' administrator, violated Section 36(b) of the 1940 Act by charging excessive management and administrative fees.

The defendants submitted a motion to dismiss the plaintiffs' claims against the Investment Adviser on the grounds that the plaintiffs failed to allege sufficient facts to satisfy the requirements of the multi-factor *Gartenberg* test used to evaluate Section 36(b) claims and that the plaintiffs' allegations were untimely because they did not allege facts occurring during the relevant damages period. The defendants also moved to dismiss the plaintiffs' claims against the Administrator, claiming that the plaintiffs failed to establish that the Administrator was a party against which a Section 36(b) claim could be brought.

On July 13, 2015, the District Court denied the defendants' motion to dismiss with respect to the claims against the Investment Adviser but granted the defendants' motion to dismiss the claims against the Administrator.

In denying the defendants' motion to dismiss the claims against the Investment Adviser, the court, citing prior case law under Section 36(b), indicated that a plaintiff's excessive fee claim may survive a motion to dismiss even if it does not specifically address all of the *Gartenberg* factors, provided that, "when taken as a whole, the complaint demonstrates a plausible claim for relief under [Section] 36(b)." The court noted that the plaintiffs did allege facts relevant to all of the *Gartenberg* factors, noting in particular the plaintiffs' claims regarding the nature and quality of the services provided by the Investment Adviser and the Investment Adviser's failure to share cost savings resulting from realized economies of scale.

Regarding the nature and quality of the services provided by the Investment Adviser, the court noted that the plaintiffs alleged the following facts: The Funds are managed under a "manager-of-managers" arrangement whereby the Investment Adviser subcontracts portfolio management responsibilities for the Funds to outside sub-advisers but retains 40% of the investment advisory fees even though the Investment Adviser is left "largely without any asset management responsibilities." The Funds pay the Investment Adviser a monthly investment advisory fee based on a percentage of the Funds' average daily net assets. Accordingly, the fees are not based on the Investment Adviser's quality of services nor on the cost of providing such services. The Funds have also demonstrated poor performance. For the 2013 fiscal year, each of the Funds underperformed its primary benchmark for the five- and ten-year periods, and three of the Funds underperformed their primary benchmark for the one-year period. The court concluded that these facts raised a plausible claim that the Investment Adviser charges investment advisory fees "that are disproportionately large in comparison to the services it provides . . . and could not have been the product of arm's length bargaining."

Regarding the failure of the Investment Adviser to share cost savings resulting from realized economies of scale, the court noted that the plaintiffs alleged the following facts: Although the Funds' assets had grown significantly (e.g., the assets of one Fund increased from $640 million in 1997 to $2.3 billion in 2015), the Funds' investment advisory fees remained set at a constant percentage of average daily net assets. In addition, the Funds' investment advisory fee schedules did not contain breakpoints, which would allow for cost savings resulting from realized economies of scale to be passed along to Fund shareholders. Accordingly, the plaintiffs claimed, "[the Investment Adviser] profits from economies of scale without sharing the benefits with the [Funds] and, in turn, investors." The court concluded that these facts supported a plausible claim for relief under Section 36(b).

On the defendants' claim that the plaintiffs' suit was time barred, the Court noted that Section 36(b) provides that "[n]o award of damages shall be recoverable for any period prior to one year before the action was instituted." The Court determined that the plaintiffs' suit was instituted on December 11, 2013 when the plaintiffs filed their initial complaint. Accordingly, the Court determined that the plaintiffs could not recover any damages for excessive fees charged before December 11, 2012. Because the plaintiffs' claims relied on financial and performance information from the Funds' fiscal years ended August 31, 2013 (for one Fund) and September 30, 2013 (for the other four Funds), the Court determined that the plaintiffs alleged facts relating to fees charged during the appropriate damages period and that the suit was not time barred.

While the Court denied the motion to dismiss the claims against the Investment Adviser, the Court was not particularly sanguine about the plaintiffs' overall case, noting that additional facts would be necessary for the Court to evaluate the strength of the plaintiffs' Section 36(b) claims under a fact-intensive review of the *Gartenberg* factors. The Court stated that while the plaintiffs' allegations were sufficient to survive a motion to dismiss, they "may well not survive summary judgment."

In granting the defendants' motion to dismiss the claims against the Administrator, the court noted that Section 36(b) authorizes an action against three categories of persons: a fund's investment adviser; an affiliated person of a fund's investment adviser; and certain persons enumerated in Section 36(a), which include a fund's officers, directors, advisory board members, depositor and principal underwriter. The Court concluded that (1) the Administrator was not the Funds' investment adviser, (2) the plaintiffs failed to allege facts indicating that the Administrator was an affiliated person of the Funds' investment adviser under the 1940 Act's definition of that term, and (3) the Administrator was not otherwise one of the enumerated persons in Section 36(a).

FINRA Sanctions Wells Fargo, Raymond James and LPL Financial for Failing to Identify and Apply Mutual Fund Sales Charge Waivers Available for Certain Retirement Accounts and Charitable Organizations

On July 6, 2015, each of Wells Fargo Advisors, LLC and Wells Fargo Advisors Financial Network, LLC (together, "Wells Fargo"), Raymond James & Associates, Inc. and Raymond James Financial Services, Inc. (together, "Raymond James") and LPL Financial LLC ("LPL") entered into a Letter of Acceptance, Waiver and Consent with the Financial Industry Regulatory Authority ("FINRA") to settle alleged rule violations in connection with each firm's failure to apply mutual fund sales charge waivers for certain retirement plan and charitable organization customers (together, "Eligible Customers").

As to each firm, FINRA alleged that, since at least July 1, 2009, the firms failed to reasonably supervise the application of sales charge waivers for eligible mutual fund sales to Eligible Customers. Although some of the funds available on each firm's platform offered waivers of up-front sales charges associated with Class A shares for Eligible Customers and disclosed those waivers in their prospectuses, FINRA alleged that the firms treated the Eligible Customers in the same manner as ordinary retail customers and, as a result, the Eligible Customers either unnecessarily paid sales charges when purchasing Class A shares or purchased other share classes that subjected them to higher ongoing fees and expenses. In each case, the firm began a review to determine whether the firm had provided available sales charge waivers to Eligible Customers. Thereafter, each firm self-reported to FINRA that Eligible Customers had not received available sales charge waivers and thus were overcharged for mutual fund purchases during the relevant periods.

By failing to reasonably supervise mutual fund sales to ensure that Eligible Customers that purchased mutual fund shares received the benefit of applicable sales charge waivers, FINRA found that each firm violated NASD Conduct Rule 3010 (for misconduct before December 1, 2014) and FINRA Rule 2010 and, with respect to Raymond James and LPL only, FINRA Rule 3110 (for misconduct on or after December 1, 2014). As part of the settlements, each firm agreed to a censure and to pay restitution to Eligible Customers of the amount estimated to have been overcharged, including interest, totaling approximately $15 million in the case of Wells Fargo, $4.5 million for Raymond James and $6.3 million with respect to LPL. LPL also agreed to pay restitution to Eligible Customers that purchased fund shares or that purchased mutual funds without an appropriate sales charge waiver during the period January 1, 2015 through the date that the firm establishes and fully implements training, systems and procedures reasonably designed to achieve compliance with the supervision of mutual fund sales waivers.

In resolving the matters, FINRA cited each firm's "extraordinary cooperation" for having: (i) initiated, prior to detection or intervention by a regulator, an investigation to identify whether Eligible Customers received sales charge waivers during the relevant period; (ii) promptly established a plan of remediation for Eligible Customers that did not receive appropriate sales charge waivers; (iii) promptly self-reported to FINRA; (iv) promptly taken action and remedial steps to correct the violative conduct; and (v) employed subsequent corrective measures, prior to detection or intervention by a regulator, to revise its procedures to avoid recurrence of the misconduct.

FINRA's announcement of the enforcement settlements with each firm is available at: https://www.finra.org/newsroom/2015/finra-sanctions-wells-fargo-raymond-james-and-lpl-30-million.

SEC Settles Charges Against Auditor, Fund Administrator and Trustee in Connection with Auditor-Trustee Relationship

On July 1, 2015, the SEC settled administrative proceedings against Deloitte & Touche LLP ("Deloitte"), the outside auditor of three closed-end funds (the "Funds"); ALPS Fund Services, Inc. ("ALPS"), an administrator of the Funds that provided compliance services; and Andrew C. Boynton, a former member of the Funds' board of trustees and the audit committee.

Deloitte

From 2006 to 2011, Deloitte Consulting LLP ("Deloitte Consulting"), an affiliate of Deloitte, maintained a business relationship with Mr. Boynton, who served as a member of the Funds' board of trustees and of the audit committee throughout that period. This relationship involved Deloitte Consulting acquiring from Mr. Boynton, among others, a brainstorming business methodology and later retaining Mr. Boynton as an outside consultant to assist in the implementation of the methodology for Deloitte Consulting clients. For his services, Deloitte Consulting paid Mr. Boynton consulting fees. During the entirety of the relationship, Deloitte served as the Funds' outside auditor, claiming independence from the Funds.

The internal policies of the parent company of Deloitte and Deloitte Consulting required that an independence consultation be performed before entering into a new business relationship with an outside consultant; however, this consultation was not performed before Deloitte Consulting entered into its arrangement with Mr. Boynton. In addition, Deloitte did not discover that the independence consultation was not performed until almost five years had passed after Deloitte Consulting's relationship with Mr. Boynton was established.

Deloitte was found to have (i) violated Rule 2-02(b) of Regulation S-X, which requires an outside auditor to maintain independence from audit clients, (ii) violated applicable standards of professional conduct under Section 4C of the Securities Exchange Act of 1934 and Rule 102(e)(1)(ii) of the SEC's Rules of Practice and (iii) caused the Funds to have violated Sections 30(a) and 20(a) of and Rule 20a-1 under the 1940 Act, which require funds to file reports of independent auditors with their annual reports and otherwise to disclose certain information regarding independent auditors and audits in SEC filings.

In settlement of these charges, Deloitte agreed to be censured and to pay disgorgement of $497,438 plus prejudgment interest of $116,478 and a civil penalty of $500,000.

ALPS

As administrator to the Funds, ALPS agreed to assist the Funds in fulfilling their responsibilities under Rule 38a-1 under the 1940 Act. Specifically, ALPS provided the Funds with a set of written Rule 38a-1 compliance policies and procedures and a Chief Compliance Officer to administer the compliance program. The Funds' policies and procedures regarding the selection, retention and engagement of an independent auditor were found to be inadequate at all relevant times. Accordingly, ALPS was found to have caused the Funds to violate Rule 38a-1. In settlement of these charges, ALPS agreed to pay a civil penalty of $45,000.

Trustee and Audit Committee Member

As a trustee and audit committee member, Mr. Boynton was required to complete an annual questionnaire indicating, among other things, his principal occupation and other positions held as well as any direct or indirect business relationship with Deloitte. Mr. Boynton never identified his relationship with Deloitte Consulting as a principal occupation or other position. Moreover, understanding that Deloitte and Deloitte Consulting were separate legal entities, Mr. Boynton did not disclose his relationship with Deloitte Consulting as an indirect business relationship with Deloitte, and Mr. Boynton did not otherwise inquire whether Deloitte Consulting's affiliation with Deloitte had any implications under conflict-of-interest or auditor independence rules. Mr. Boynton was found to have caused the Funds to violate Sections 30(a) and 20(a) of and Rule 20a-1 under the 1940 Act. In settlement of these charges, Mr. Boynton agreed to pay disgorgement of $30,000 plus prejudgment interest of $5,329 and a civil penalty of $25,000.

The SEC's order instituting administrative and cease-and-desist proceedings is available at: http://www.sec.gov/litigation/admin/2015/34-75343.pdf

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.

Other News and Developments

IRS Identifies Certain Basket Derivatives as Reportable Transactions

On July 8, 2015, the Internal Revenue Service (the "IRS") identified as reportable transactions certain derivative contracts that reference a basket of assets. The transactions identified by the IRS are referred to by the IRS as "basket option contracts" or "basket contracts." In these transactions, a purchaser enters into a contract that is denominated as an option, a notional principal contract (e.g., a swap), a forward contract or other derivative contract with a counterparty to receive a return based on the performance of a notional basket of referenced assets (the "reference basket"). The reference basket may include (1) "actively traded personal property" (e.g., publicly traded stock), (2) interests in hedge funds or other entities that trade securities, commodities, foreign currency or similar property, (3) securities, (4) commodities, (5) foreign currency, or (6) similar property or positions in such property. The purchaser or a designee named by the purchaser will either determine the assets that comprise the reference basket or design or select a trading algorithm that determines the assets. While the contract remains open, the purchaser has the right to request changes in the assets in the reference basket or the specified trading algorithm.

The purchaser generally takes the position that short-term gains and interest, dividend and other ordinary periodic income from the performance of the reference basket is deferred until the instrument terminates and, if the instrument is held for more than one year, that the entire gain is treated as long-term capital gain. According to the IRS, the purchaser may be using the instrument to inappropriately defer income recognition, convert ordinary income and short-term capital gain into long-term capital gain and/or avoid U.S. withholding tax.

Anyone who has participated in a basket option contract, basket contract or substantially similar transaction is now subject to certain IRS reporting obligations. The following parties are generally considered participants by the IRS and are, therefore, subject to these reporting obligations: (1) the purchaser, (2) if the purchaser is a partnership, any general partner of the purchaser, (3) if the purchaser is a limited liability company, any managing member of the purchaser, and (4) the counterparty.

Each participant in a basket option contract, basket contract or substantially similar transaction that was in effect on or after January 1, 2011 must report the transaction to the IRS, provided that the period of limitations did not end on or before July 8, 2015. If a participant has already filed its tax return for a year in which it participated in a basket option contract, basket contract or substantially similar transaction and the period of limitations has not ended, the participant needs to report the transaction to the IRS by November 5, 2015. Significant penalties and an extended statute of limitations may apply if a reportable transaction is not timely reported. In addition to the reporting obligations, a participant in a reportable transaction must also retain copies of all material documents and other records relating to the transaction.

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