

# Investment Services Regulatory Update

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## Litigation and Enforcement Actions

### SEC Settles Charges Against Advisory Firms for Failing to Disclose Changes in Investment Strategy of Closed-End Fund

On October 19, 2015, the SEC announced settled administrative proceedings against UBS Willow Management L.L.C. (“UBS Willow”) and its former controlling member, UBS Fund Advisor L.L.C. (“UBS Advisor” and together with UBS Willow, “UBS”) for misrepresentations and omissions concerning a material change in the investment strategy of UBS Willow Fund L.L.C., a continuously offered, closed-end registered investment company and UBS Willow’s sole client.

According to the order, from the Fund’s inception in May 2000, UBS marketed the Fund as a product that primarily invested in distressed debt which, the order states, is “a thesis that debt would *increase* in value” (emphasis in original). The SEC found that UBS adhered to this investment strategy until 2008, when it “changed course and shorted credit (i.e., a thesis that debt would *decrease* in value)” (emphasis in original) by purchasing large amounts of credit default swaps (“CDS”) for the Fund. The order states that the CDS exposure, which, in market value terms, increased from 2.6% of net assets at the beginning of 2008 to 25% by the end of the first quarter of 2009, was the “primary driver of the Fund’s performance,” made the Fund more volatile and resulted in significant losses. The SEC noted that the Fund’s board of directors determined to liquidate the Fund in 2012 due, at least in part, to the losses incurred by the Fund from CDS exposure.

The SEC found that UBS did not adequately disclose to the board or investors the Fund’s change in investment strategy, including the “significant, known risks posed by the Fund’s large CDS exposure.” As an example, the order states that on the morning of a May 2009 board meeting, UBS received the results of a stress test showing large potential CDS losses. The SEC found that UBS neither informed the board of the stress test results nor reported to the board on the substantial cost of maintaining the CDS positions, which, by 2010, annually exceeded 25% of the Fund’s net assets. In addition, according to the SEC, UBS provided prospective investors with an offering memorandum that described the Fund’s original long-credit principal investment strategy of investing in distressed debt, a description that was materially false beginning in fall 2008. Similarly, the SEC found that the Fund’s registration statement and the semi-annual and annual shareholder reports were never updated to reflect the change in investment strategy.

As a result of the foregoing conduct, the SEC found that, among other things, UBS Willow violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which prohibit making untrue statements of material fact and engaging in any fraud or deceit in the offer or sale of securities, and Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any fraud or deceit upon any client or prospective client. The SEC also found that UBS Willow violated the Advisers Act and the 1940 Act as a result of the alleged misrepresentations to investors in the Fund’s offering memorandum, marketing brochure, investor letters, shareholder reports and registration statement. UBS Advisor, as the controlling member of UBS Willow, also was found by the SEC to have violated Section 203(e)(6) of the Advisers Act for failing to reasonably supervise UBS Willow.

Pursuant to the terms of the order, UBS Advisor and UBS Willow agreed to compensate investors in the Fund for losses in the amount of \$4,903,620 attributable to the change in the Fund's investment strategy, pay a civil money penalty of \$4,373,436.74, disgorge \$8,223,110 in revenues and cease and desist from any violations and future violations of the laws violated by the foregoing conduct. UBS Advisor and UBS Willow were also censured.

The SEC order in the matter of UBS Advisor and UBS Willow is available at: <http://www.sec.gov/litigation/admin/2015/33-9964.pdf>.

## U.S. District Court Rules on Defendants' Motion to Dismiss in Schwab Case Relating to Violation of Fundamental Investment Policies

On October 5, 2015, the U.S. District Court for the Northern District of California issued an order granting in part and denying in part the defendants' motion to dismiss the plaintiffs' complaint in the shareholder class action originally brought in August 2008 by Northstar Financial Advisors, Inc. ("Northstar"), 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"). In doing so, the District Court let stand the plaintiffs' breach of fiduciary duty claims against Schwab Investments' trustees and CSIM but dismissed all of the plaintiffs' other claims, including those resting on novel breach of contract theories.

The following is a summary of the litigation to date:

In August 2008, Northstar filed a shareholder class action lawsuit 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 28, 2015, in a two-to-one decision, a three-judge panel of the Ninth Circuit rejected the defendants' petition for a rehearing.

On June 25, 2015, in response to the Ninth Circuit's decision, the plaintiffs filed a new amended complaint asserting breach of fiduciary duty claims against Schwab Investments, Schwab Investments' board of trustees and CSIM; direct breach of contract claims against CSIM relating to the 1997 proxy vote and the fund's prospectuses; breach of contract claims against CSIM under the third-party beneficiary theory relating to the investment advisory contract; and claims against Schwab Investments' board of trustees and CSIM for breach of the covenant of good faith and fair dealing.

On July 24, 2015, the defendants again moved to dismiss all claims.

On July 27, 2015, the defendants filed a petition for a writ of certiorari with the U.S. Supreme Court, requesting that the Supreme Court review certain of the Ninth Circuit's holdings. Specifically, the defendants requested that the Supreme Court review the Ninth Circuit's holding that Northstar could cure its lack of standing after the date of the original pleading by having a shareholder assign to Northstar its claim. The defendants argued that this ruling directly conflicted with decisions of at least two other U.S. circuit courts of appeals, was contrary to Supreme Court jurisprudence establishing that standing must exist at the time a complaint is filed, presented "a vitally important question" and caused confusion among lower courts. The defendants also requested that the Supreme Court review the Ninth Circuit's holding that disclosures in documents filed with the SEC create contracts that can be enforced through common law breach-of-contract claims. The defendants argued that this ruling was unworkable, misconstrued and improperly sidestepped the federal securities laws, created a means to penalize mutual funds for compliance with the federal securities laws, impaired the uniform regulation of nationally traded securities in conflict with federal law and established an unprecedented theory that is inconsistent with previous decisions of the Supreme Court and other federal courts.

The plaintiffs filed a brief in opposition on August 26, 2015.

On August 28, 2015, the Investment Company Institute ("ICI") and the Independent Directors Council ("IDC") filed a joint amicus brief supporting the defendants' petition, arguing that granting certiorari in this case was warranted because of the "immediate and far-reaching threat to mutual funds and their investors" presented by the Ninth Circuit's decision. The ICI and IDC further argued that the Ninth Circuit's ruling that SEC disclosures may create enforceable contracts improperly turns a federally mandated disclosure document into a privately enforceable contract in a manner that conflicts with the comprehensive federal regulatory framework applicable to mutual funds. Also on August 28, 2015, a second amicus brief in support of the defendants was filed by the Mutual Fund Directors Forum, and a third amicus brief in support of the defendants was filed jointly by Pacific Life Fund Advisors, LLC, Capital Research and Management Co., AssetMark Inc., Wells Fargo Fund Management, LLC and Russell Investments.

On October 5, 2015, the U.S. Supreme Court announced that it had denied the defendants' petition for a writ of certiorari. In denying the defendants' petition, the Supreme Court declined to review the earlier decision of the U.S. Court of Appeals for the Ninth Circuit in the case, effectively allowing the Ninth Circuit's decision to stand.

Also on October 5, 2015, as stated above, the U.S. District Court for the Northern District of California granted in part and denied in part the defendants' motion to dismiss all claims in the plaintiffs' June 25, 2015 amended complaint.

The District Court denied on procedural grounds the defendants' motion to dismiss the plaintiffs' entire complaint based on SLUSA preclusion. The District Court also denied the defendants' motion to dismiss breach of fiduciary duty claims against Schwab Investments' trustees and CSIM, allowing these claims to stand. Of note, following the Ninth Circuit's decision, the District Court found that CSIM, as investment adviser to the Schwab Total Return Bond Fund, owed a fiduciary duty to fund shareholders.

The District Court granted the defendants' motion to dismiss with respect to the plaintiffs' remaining claims.

The District Court granted the defendants' motion to dismiss breach of fiduciary duty claims against Schwab Investments, agreeing with the defendants that no fiduciary duty is owed by a Massachusetts business trust to its shareholders.

The District Court also granted the defendants' motion to dismiss the plaintiffs' direct breach of contract claims relating to the 1997 proxy vote and the fund's prospectuses and third-party beneficiary claims under the investment advisory contract, agreeing with the defendants that these claims were precluded by SLUSA. In dismissing these claims, the District Court concluded that these claims were essentially based on misrepresentation—the plaintiffs' alleged that Schwab Investments, in the fund's 1997 proxy statement and later prospectuses, and CSIM, in the investment advisory agreement, represented to shareholders that they would do one thing but did another thing. In addition, with respect to the breach of contract claims relating to the 1997 proxy vote, the District Court concluded that the claims were not "voter claims" involving misrepresentations occurring prior to a shareholder vote that would have deprived shareholders from making an informed decision (which may be eligible for a carve-out from SLUSA preclusion), but rather "holder claims" involving misrepresentations to shareholders made years after a shareholder vote.

Finally, the District Court granted the defendants' motion to dismiss the plaintiffs' claims alleging a breach of the covenant of good faith and fair dealing. The covenant of good faith and fair dealing is an implied covenant in a contract. Because the plaintiffs' breach of contract claims were dismissed with prejudice, the District Court determined that claims of a breach of the covenant of good faith and fair dealing were no longer viable.

## SEC Settles Charges Against Investment Adviser for Failing to Adopt Adequate Cybersecurity Policies and Procedures in Advance of Data Breach

On September 22, 2015, the SEC announced settled administrative proceedings against R.T. Jones Capital Equities Management, Inc. ("RTJ"), a registered investment adviser, for failing to adopt written policies and procedures regarding the security and confidentiality of sensitive client information and the protection of that information from anticipated threats or unauthorized access pursuant to Rule 30(a) of Regulation S-P under the Securities Act (the "Safeguards Rule"). As noted in the order, the Safeguards

Rule, which the SEC adopted in 2000, requires SEC-registered brokers/dealers, investment companies and investment advisers to adopt policies and procedures reasonably designed to: (1) insure the security and confidentiality of customer records and information; (2) protect against any anticipated threats or hazards to the security or integrity of customer records and information; and (3) protect against unauthorized access to or use of customer records or information that could result in substantial harm or inconvenience to any customer.

According to the SEC, RTJ provided portfolio allocation models and recommendations to retirement plan participants through a program that participants could access on RTJ's public website. The SEC found that from September 2009 through July 2013, in order to verify eligibility to enroll in the program, RTJ required prospective clients to log on to its website by providing certain personal information, which RTJ compared against sensitive "personally identifiable information" ("PII") of eligible plan participants provided to RTJ by its plan sponsor partners. According to the order, to facilitate the verification process, the plan sponsors provided RTJ with PII of all of their plan participants, which RTJ stored, without modification or encryption, on its third party-hosted web server. Consequently, the order states that "even though [RTJ] had fewer than 8000 plan participant clients, its web server contained the PII of over 100,000 individuals."

According to the SEC, in July 2013, RTJ discovered a potential cybersecurity breach on its third party-hosted web server, rendering the PII vulnerable to theft. The order states that RTJ promptly hired multiple cybersecurity firms to review the breach, but, ultimately, the cybersecurity firms could not determine the full nature or extent of the breach or whether the PII stored on the server had been accessed or compromised. The SEC noted that RTJ notified the affected individuals and offered them free identity theft monitoring.

The SEC ordered that RTJ cease and desist from committing or causing future violations of the Safeguards Rule, censured the firm and required RTJ to pay a \$75,000 civil penalty. In determining to accept RTJ's settlement offer, the SEC considered RTJ's remedial efforts, including the appointment of an information security manager to oversee data security and protection of PII, adoption and implementation of a written information security policy, installation of a new firewall and logging system to prevent and detect malicious incursions and the retention of a cybersecurity firm to provide ongoing reports and advice on the firm's information technology security.

The SEC order in the matter of RTJ is available at: <http://www.sec.gov/litigation/admin/2015/ia-4204.pdf>.

## SEC Settles First Charges Brought Under Distribution-in-Guise Initiative

On September 21, 2015, the SEC issued an order instituting a settled administrative proceeding against First Eagle Investment Management, LLC, a registered investment adviser ("First Eagle"), and its wholly-owned broker-dealer subsidiary, FEF Distributors, LLC ("FEF"), for improper use of mutual fund assets to pay for the distribution and marketing of fund shares. An SEC press release announcing the order noted that "[t]he case is the first arising out of a recent SEC initiative to protect mutual fund shareholders from bearing the costs when firms improperly use fund assets to pay for distribution-related services."



As stated in the order, Section 12(b) of the 1940 Act and Rule 12b-1 thereunder make it unlawful for any registered open-end management investment company to engage “directly or indirectly in financing any activity which is primarily intended to result in the sale of shares issued by such company” unless such financing is made pursuant to a written plan that meets the requirements of Rule 12b-1.

According to the SEC, in an effort to expand the distribution of the shares of the First Eagle Funds, FEF, the Funds’ the principal underwriter and distributor, entered into distribution relationships with various financial intermediaries, including two firms identified in the order as “Intermediary One” and “Intermediary Two.”

### **Intermediary One**

The SEC found that in June 2000, FEF entered into two agreements with Intermediary One: a Financial Services Agreement and a Selected Dealer Agreement. Pursuant to the Financial Services Agreement, Intermediary One agreed to provide a variety of sub-TA services, for which it charged fees ranging between \$16-\$19 per account. The Funds paid these fees. Pursuant to the Selected Dealer Agreement, Intermediary One agreed to become a selected dealer to “distribute shares” of the Funds and to provide services which included due diligence, legal review, training and “marketing.” According to the SEC, for these services, the Selected Dealer Agreement stated that Intermediary One would receive, in addition to Rule 12b-1 plan fees paid by the Funds: (1) a one-time fee of \$50,000; (2) 25 basis points of total new gross sales of shares of any class sold by Intermediary One; and (3) 10 basis points of the value of Fund shares sold by Intermediary One that are held for more than one year.

As stated in the SEC’s order, under the terms of the Selected Dealer Agreement, during the period from January 1, 2008 through March 31, 2014, First Eagle and FEF caused the Funds to pay approximately \$25 million to Intermediary One for services that the SEC found were “generally marketing and distribution” and not made pursuant to the Funds’ Rule 12b-1 plan.

### **Intermediary Two**

According to the SEC, in December 2007, FEF entered into a Correspondent Marketing Program Participation Agreement (the “Correspondent Agreement”) with Intermediary Two; however, the SEC found that the Funds had essentially been paying for the same services since 2005. As stated in the SEC’s order, pursuant to the Correspondent Agreement, Intermediary Two agreed, among other things, to provide email distribution lists of correspondent broker-dealers that request “sales and marketing concepts” from Intermediary Two, market the Funds on its internal website, invite the Funds to participate in special marketing promotions and offerings to correspondent broker-dealers and provide quarterly statements detailing which correspondent broker-dealers were selling the Funds. In exchange for these services, Intermediary Two received fees based upon the net asset value of outstanding shares of the Funds it sold.

The SEC found that First Eagle and FEF caused the Funds to pay approximately \$290,000 to Intermediary Two pursuant to the Correspondent Agreement during the relevant time period. As with the Selected Dealer Agreement with Intermediary One, the SEC found that the services provided by

Intermediary Two under the Correspondent Agreement were generally marketing and distribution and not sub-transfer agent services. Consequently, the SEC found that First Eagle and FEF were prohibited from using the Funds' assets to pay Intermediary Two under the Correspondent Agreement outside of a written, approved 12b-1 plan.

The SEC order stated that First Eagle periodically reported to the Funds' board of trustees regarding payments for distribution and sub-TA services and consulted with its outside counsel regarding such payments, including in connection with a review by outside counsel of First Eagle's practices with respect to payments for sub-TA services. According to the SEC, the results of the foregoing review--which First Eagle shared with the board--indicated that all of the fees paid to Intermediary One and Intermediary Two under the Financial Services Agreement, Selected Dealer Agreement and Correspondent Agreement, respectively, were for sub-TA services.

As a result of the foregoing conduct, the SEC found that, among other things, First Eagle and FEF violated Section 12(b) of the 1940 Act and Rule 12b-1 thereunder. Pursuant to the terms of the order, First Eagle was censured and ordered to cease and desist from committing or causing any violations and any future violations of Section 206(2) of the Advisers Act, and Sections 12(b) and 34(b) of the 1940 Act and Rule 12b-1 thereunder. FEF also was subjected to a cease and desist order with respect to Section 12(b) of the 1940 Act and Rule 12b-1. In addition, First Eagle and FEF agreed to certain undertakings to enhance their compliance program and were ordered to pay disgorgement, prejudgment interest and a civil monetary penalty totaling approximately \$40 million, a portion of which will be used to reimburse Fund shareholders.

The SEC order in the matter of First Eagle and FEF is available at: <http://www.sec.gov/litigation/admin/2015/ia-4199.pdf>.

## SEC Grants Petition for Review of Dismissal of Charges Against Investment Advisory Firm

In September 2014, the SEC issued an order instituting administrative proceedings against respondents The Robare Group, Ltd., a registered investment adviser ("Adviser") and its principals, Mark Robare and Jack Jones, Jr., alleging violations of the Advisers Act based on the Adviser's failure to disclose financial incentives it had in recommending particular mutual funds to its advisory clients. Specifically, the SEC alleged that the Adviser failed to disclose in its Form ADV compensation it received through a commission schedule and servicing fee agreement (the "Agreement") with a registered broker-dealer ("Broker") for client assets that were invested in certain mutual funds offered on the Broker's platform and the conflicts of interest to clients arising from that compensation arrangement. According to the SEC's allegations, from 2005 until the Adviser filed its December 2011 Form ADV, the Adviser failed to disclose the existence of the Agreement, which had been executed in 2004; beginning in December 2011, the SEC alleged, the Adviser inadequately disclosed the arrangement and "still failed to disclose that it had an incentive to prefer certain [mutual] funds as a result of the arrangement."

On June 4, 2015, an SEC administrative law judge issued an initial decision dismissing all charges against the respondents after finding, among other things, that the SEC failed to show that the

respondents acted with scienter. Of note, the administrative law judge concluded that the respondents had prepared the Form ADV disclosure in question in reliance in good faith upon the advice of third-party compliance consultants, and that the consultants' advice was "facially valid."

On June 25, 2015, the SEC Division of Enforcement filed a petition for review of the initial decision, seeking reversal of the administrative law judge's decision to dismiss, a finding of liability and the imposition of sanctions. The Division of Enforcement's petition took issue with the judge's decision as a matter of public policy, claiming that the decision "shifts the burden of fully disclosing a conflict of interest from an investment adviser, who has a fiduciary duty to and a relationship with clients, to a compliance consultant (who has no such connection)." The Division asserted that the administrative law judge's decision, if allowed to stand, could "significantly weaken the long-standing fiduciary standards applicable to investment advisers." On July 10, 2015, the respondents moved for summary affirmance of the administrative law judge's decision.

On August 12, 2015, the SEC issued an order denying the respondents' petition for summary affirmance and granting the Division of Enforcement's petition for review. In granting the petition for review, the SEC noted the "potentially important matters of public interest this case presents . . . ." The Division has until September 11, 2015 to file a brief in support of the petition for review. The respondents' brief in opposition must be filed by October 12, 2015, and any reply brief must be filed by October 26, 2015.

## Seventh Circuit Affirms District Court on Remand in *Jones v. Harris Associates*

On August 6, 2015, on remand from the U.S. Supreme Court, the Court of Appeals for the Seventh Circuit affirmed the 2007 decision by the District Court granting summary judgment to defendant Harris Associates in *Jones v. Harris Associates*, which had found that investors in the Oakmark mutual funds failed to establish that they had been charged excessive advisory fees. In a four-page order (including an acknowledgment that the Seventh Circuit's opinion was delayed following the Supreme Court's remand due to misplaced papers and a tracking system gap), the Seventh Circuit applied the *Gartenberg* standard embraced by the Supreme Court in a unanimous decision issued in March 2010: to face liability under §36(b) of the 1940 Act, an investment adviser must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining. In this connection, the Seventh Circuit turned aside the plaintiffs' contention that Harris's fees should be deemed excessive because they were not approved through proper procedures, explaining that a process-based failure alone does not constitute an independent violation of §36(b). Instead, Circuit Judges Frank Easterbrook and Michael Kanne stated in the opinion, "we have been instructed that §36(b) is sharply focused on the question of whether the fees themselves were excessive" (citing *Gallus v. Ameriprise Financial*). The Seventh Circuit's decision further states that although the district court applied a legal standard similar to the one eventually adopted by the Supreme Court, the standards are "not identical, because the Supreme Court's approach does not allow a court to assess the fairness or reasonableness of advisers' fees; the goal is to identify the outer bounds of arm's length bargaining and not engage in rate regulation. This means that the Supreme Court's standard is less favorable to plaintiffs than the one the district court used- yet plaintiffs lost even under the district

court's approach." Turning to the District Court's findings, the Seventh Circuit noted that there was no material dispute about four propositions, "which collectively require a decision for Harris": (1) Harris's fees were in line with those charged by advisers for other comparable funds; (2) Harris provided accurate information to the funds' boards, whose disinterested members approved the fees; (3) the fee schedules included breakpoints; and (4) the fees could not be called disproportionate in relation to the value of Harris's work because the funds' returns (net of fees) "exceeded the norm for comparable investment vehicles." The Seventh Circuit added that the plaintiffs "seek to avoid the implications of [the foregoing] facts" by comparing the fees that Harris charged the Oakmark funds with the fees that Harris charged some of its other clients, such as pension funds. However, the Circuit Judges stated that their initial opinion rejected this contention and the "Supreme Court did not disagree with us," noting the Supreme Court's position that "courts may give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require," but courts must be "wary of inapt comparisons" between fees charged to different types of clients. The Seventh Circuit concluded that because the plaintiffs did not provide any evidence that "would tend to show that Harris provided pension funds (and other non-public clients) with the same sort of services that it provided to the Oakmark funds, or that it incurred the same costs when serving different types of clients," it had no basis to justify "a further inquiry" of these comparisons under the Supreme Court's approach..

## New Rules, Proposed Rules and Guidance

### SEC Proposes New Liquidity Risk Management Rules for Mutual Funds and ETFs

On September 22, 2015, the SEC unanimously approved a proposal that is intended to promote effective liquidity risk management by open-end investment companies, reduce the risk that funds will be unable to meet redemption obligations and mitigate the dilution of shareholder interests.

Under the proposal, mutual funds and exchange-traded funds (ETFs), but not money market funds, would be required to establish a liquidity risk management program and disclose fund liquidity and redemption practices, such as the methods that a fund uses to meet redemption requests and the number of days in which a fund will pay redemption proceeds to redeeming shareholders. If the number of days in which a fund will pay redemption proceeds differs by distribution channel (e.g., broker-dealer channel, omnibus account channel, retirement plan channel, etc.), a fund also would be required to disclose the number of days for each distribution channel. Additionally, the proposal would provide a framework in which funds could elect to use "swing pricing" to reflect in their net asset value costs associated with shareholder trading activity during periods of heavy redemptions or purchases.

In connection with the proposed disclosure and reporting reforms, the SEC is re-opening the comment period for the proposed investment company reporting reforms announced earlier this year because the new proposal includes amendments to the previously proposed Form N-PORT and Form N-CEN.

## Liquidity Risk Management Programs

Proposed Rule 22e-4 under the 1940 Act would require funds to adopt and implement written liquidity risk management programs, including the following elements:

- **Liquidity Classification of Portfolio Investments:** Funds would be required to indicate the liquidity classification of each of the fund's positions in a portfolio asset using the following specified categories: (1) convertible to cash within 1 business day; (2) convertible to cash within 2-3 business days; (3) convertible to cash within 4-7 calendar days; (4) convertible to cash within 8-15 calendar days; (5) convertible to cash within 16-30 calendar days; and (6) convertible to cash in more than 30 calendar days. For portfolio assets with multiple liquidity classifications, the proposed rule would require funds to indicate the dollar amount attributable to each classification. Such information would be made available to the public quarterly on proposed Form N-PORT.
- **Determination of Three-Day Liquid Asset Minimum:** The proposed rule would require each fund to determine its "three-day liquid asset minimum," which is the percentage of the fund's net assets to be invested in three-day liquid assets. The proposed definition of three-day liquid asset is any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale. The three-day liquid asset minimum would be determined based on an assessment of short-term and long-term cash flow projections, the investment strategy and liquidity of the fund's portfolio assets, the use of borrowings and derivatives for investment purposes, holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources. A fund's board would be required to approve the fund's three-day liquid asset minimum and a fund would be required to maintain a written record of how the fund's three-day liquid asset minimum was determined.
- **Assessment, Review and Management of Liquidity Risk:** The proposed rule would require a fund to assess and periodically review its liquidity risk and manage such risk based on this assessment. In this connection, a fund would be prohibited from acquiring any less liquid asset if the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets. In addition, the proposal codifies current SEC guidance that limits a mutual fund's ability to invest in illiquid assets to 15% of the fund's net assets.
- **Reports to Fund Boards:** A fund's investment adviser or officers administering the fund's liquidity risk management program would be required to submit written reports to the fund's board concerning the adequacy of the fund's liquidity risk management program, including the fund's three-day liquid asset minimum, and the effectiveness of its implementation. Board approval would be required for any changes to the fund's three-day liquid asset minimum.

The requirements of proposed Rule 22e-4, including the liquidity risk assessment requirements, are applicable to each series of a registered open-end investment company, meaning that each series requires a liquidity risk management program tailored to its own liquidity risk. The proposing release acknowledges that it may be appropriate for multiple series to adopt the same or a similar liquidity

risk management program to the extent that such series are “substantially similar in terms of cash flow patterns, investment strategy, portfolio liquidity, and the other factors a fund would be required to consider in assessing its liquidity risk.”

### **Swing Pricing**

The SEC also is proposing amendments to Rule 22c-1 under the 1940 Act that would allow, but not require, mutual funds (excluding ETFs and money market funds) to adjust their net asset value when the level of purchases or redemptions exceed certain pre-approved “swing thresholds.” Under the proposal, a fund’s board would be required to: (i) approve the methodologies for calculating the swing threshold and the adjustment factor and (ii) conduct an annual review of swing pricing policies and procedures. The SEC notes that the proposed amendments to Rule 22c-1 are designed to protect existing shareholders from dilution associated with shareholder purchases and redemptions.

### **Disclosure and Reporting Requirements**

The SEC is proposing several amendments to Form N-1A and proposed Form N-PORT and Form N-CEN, including:

- Form N-1A: Funds would be required to disclose their liquidity risk management practices, including the methods used to meet shareholder redemptions and the use of “swing pricing,” if applicable. In addition, the proposal would require a fund to file any agreements related to lines of credit for the benefit of the fund as exhibits to its registration statement. (The specific fees paid in connection with credit agreements need not be disclosed in the exhibit proposed to be filed with the SEC.)
- Form N-PORT: Funds would be required to report the liquidity classifications assigned to individual portfolio securities and the three-day liquid asset minimum.
- Form N-CEN: Funds would be required to disclose information regarding committed lines of credit, swing pricing and interfund borrowing and lending, to the extent applicable.

Comments on the proposed rules must be received by the SEC on or before January 13, 2016. The proposing release is available at: <http://www.sec.gov/rules/proposed/2015/33-9922.pdf>.

## **SEC Issues Final Rule for Removal of Certain References to Credit Ratings and Amends the Issuer Diversification Requirement in the Money Market Fund Rule**

On September 16, 2015, the SEC adopted amendments to remove references to credit ratings from Rule 2a-7 and eliminate an exclusion from Rule 2a-7’s issuer diversification provisions. The amendment removing credit rating references implements a requirement of the Dodd-Frank Act, which directed each federal agency, including the SEC, to review its rules and replace any reference to or requirement of reliance on credit ratings with a standard of credit-worthiness that the agency determines is appropriate for its regulations.

### **Determination of Eligible Securities**

Currently, Rule 2a-7 requires money market funds to limit portfolio investments to securities that are “eligible securities,” as defined generally by reference to credit ratings provided by “nationally recognized statistical rating organizations” (each, an “NRSRO”), and that have been determined by the fund’s board (or its delegate) to pose “minimal credit risks” to the fund. Since minimal credit risk is not defined in Rule 2a-7, the money market fund industry has relied on SEC staff guidance regarding the credit quality factors that may be used to determine that a security presents minimal credit risks.

As amended, Rule 2a-7 codifies this guidance and adopts a revised standard for eligible securities requiring a single uniform minimal credit risk finding. Consequently, in making its minimal credit risk determinations, a money market fund’s board (or its delegate) will be required to consider “the capacity of each security’s issuer, guarantor, or provider of a demand feature, to meet its financial obligations, and in doing so, consider, to the extent appropriate, the following factors: (1) financial condition; (2) sources of liquidity; (3) ability to react to future market-wide and issuer- or guarantor-specific events, including ability to repay debt in a highly adverse situation; and (4) strength of the issuer or guarantor’s industry within the economy and relative to economic trends, and issuer or guarantor’s competitive position within its industry.”

The adopting release advises that the financial condition factor generally should include examination of recent financial statements, including consideration of trends relating to cash flow, revenue, expenses, profitability, short-term and total debt service coverage, and leverage. As to sources of liquidity, bank lines of credit and alternative sources of liquidity should be considered. The third factor, involving market-wide events, generally should include analysis of risk from “various scenarios, including changes to the yield curve or spreads, especially in a changing interest rate environment.” The fourth factor, the competitive position of the firm and its industry, generally should include “consideration of diversification of sources of revenue, if applicable.” Finally, the adopting release adds that a minimal credit risk evaluation also may include “consideration of whether the price and/or yield of the security itself is similar to that of other securities in the fund’s portfolio.”

### **Monitoring Minimal Credit Risks**

Rule 2a-7 currently requires a money market fund board (or its delegate) to promptly reassess whether a security that has been downgraded by an NRSRO continues to present minimal credit risks. As amended, Rule 2a-7 will require a money market fund to adopt written procedures requiring the fund’s adviser to provide ongoing review of each portfolio security to determine that the issuer continues to present minimal credit risks.

### **Recordkeeping**

The SEC adopted a conforming change to the recordkeeping requirements under Rule 2a-7 to reflect that funds must retain a written record of the determination that a portfolio security is an eligible security, including the determination that it presents minimal credit risks, at the time the fund acquires the security, or at such later times (or upon such events) that the fund’s board determines the investment adviser must reassess whether the security presents minimal credit risks.

### Exclusion from the Issuer Diversification Requirement

Under current Rule 2a-7, a money market fund's portfolio must be diversified both as to the issuers of the securities it acquires and providers of guarantees (and demand features) related to those securities. Generally, money market funds must limit their investments in the securities of any one issuer of a "first tier security" to no more than 5% of total assets, other than with respect to government securities and securities subject to a guarantee by a non-controlled person. Thus, Rule 2a-7 currently does not require a money market fund to be diversified with respect to issuers of securities that are subject to a guarantee by a non-controlled person. The Rule amendments adopted by the SEC eliminate the current exclusion to the issuer diversification requirement for such securities.

The effective date of the Rule amendments is October 26, 2015. The compliance date is October 14, 2016. The adopting release is available at: <http://www.sec.gov/rules/final/2015/ic-31828.pdf>.

## OCIE Identifies Focus Areas for Second Round of Cybersecurity Sweep Exams

On September 15, 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert to provide additional information on the focus areas for OCIE's second round of cybersecurity examinations of registered broker-dealers and investment advisers. The Risk Alert is the latest publication by the SEC staff concerning cybersecurity compliance and controls, which OCIE included among its 2015 examination priorities.

In April 2014, OCIE announced the first round of sweep examinations intended to identify cybersecurity risks and assess cybersecurity preparedness in the securities industry. In February 2015, OCIE issued a Risk Alert providing summary observations derived from the first round of examinations, which included interviews with key personnel and evaluation of materials from 57 registered broker-dealers and 49 registered investment advisers relating to the firms' practices for: identifying cybersecurity-related risks; establishing cybersecurity governance, including policies, procedures and oversight processes; identifying and responding to risks relating to service providers, vendors and other third parties; safeguarding network infrastructure and information; identifying and managing risks associated with remote access to client information and funds transfer requests; and uncovering unauthorized activity.

In the recently released Risk Alert, OCIE indicated that the second round of sweep examinations will involve more testing to assess implementation of firm procedures and controls. In this connection, OCIE identified several key focus areas, including:

- **Governance and Risk Assessment:** Examiners may assess whether firms: (i) have cybersecurity governance and risk assessment processes related to the other key areas of focus described below; (ii) are periodically evaluating cybersecurity risks and whether their controls and risk assessment processes are tailored to their business; and (iii) are involving senior management/boards of directors and to what extent.



- **Access Rights and Controls:** Examiners may review how firms control access to various systems and data via management of user credentials, authentication, and authorization methods. This review may include a review of controls associated with remote access, customer logins, passwords, firm protocols to address customer login problems, network segmentation, and tiered access.
- **Data Loss Prevention:** Examiners may assess how firms: (i) monitor the volume of content transferred outside of the firm by their employees or through third parties (e.g., by email attachments or uploads); (ii) monitor for potentially unauthorized data transfers; and (iii) verify the authenticity of a customer request to transfer funds.
- **Vendor Management:** Examiners may assess: (i) firm practices and controls related to vendor management (e.g., due diligence with regard to vendor selection, monitoring and oversight of vendors, and contract terms); (ii) how vendor relationships are considered as part of the firm's ongoing risk assessment process; and (iii) how the firm determines the appropriate level of due diligence to conduct on a vendor.
- **Training:** Examiners may assess how: (i) training is tailored to specific job functions and how training is designed to encourage responsible employee and vendor behavior; and (ii) procedures for responding to cyber incidents under an incident response plan are integrated into regular personnel and vendor training.
- **Incident Response:** Examiners may assess whether firms have established policies, assigned roles, assessed system vulnerabilities, and developed plans to address possible future events (including determining which firm data, assets, and services warrant the most protection to help prevent attacks from causing significant harm).

In connection with "OCIE's efforts to promote compliance and to share with the industry where it sees cybersecurity-related risks," OCIE included with the Risk Alert a sample request for information and documents to be used in the second round of sweep examinations. The Risk Alert, including the sample information request, is available at: <http://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf>.

## FinCEN Proposes Anti-Money Laundering Rules for Registered Investment Advisers

On August 25, 2015, the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of the Treasury, issued a notice of proposed rulemaking that would require registered investment advisers to establish anti-money laundering ("AML") programs and to report suspicious activity to FinCEN pursuant to the Bank Secrecy Act ("BSA"). The proposed rule seeks to address money laundering vulnerabilities in the U.S. financial system, specifically to prevent illicit actors from using an investment adviser as a means to avoid detection of their activity, which might otherwise occur in dealing with financial institutions that have AML programs and suspicious activity reporting requirements. FinCEN is proposing three significant regulatory changes:

- The proposed rule would include all investment advisers that are registered with the SEC or required to be registered with the SEC under Section 203 of the Advisers Act (generally, investment advisers with assets under management of \$100 million or more) within the scope of “financial institutions” for purposes of the BSA, thus subjecting such advisers to all BSA regulatory requirements generally applicable to other financial institutions (e.g., the requirement to file currency transaction reports and comply with recordkeeping requirements relating to the transmittal of funds).
- The proposed rule would require registered investment advisers to develop, implement and monitor a written AML program reasonably designed to prevent the adviser from being used as a conduit to facilitate money laundering or finance terrorist activities and to achieve compliance with the applicable provisions of the BSA and FinCEN implementing regulations. Specifically, a registered investment adviser would be required, among other things, to: (1) adopt and implement policies, procedures and internal controls based upon the adviser’s assessment of the money laundering or terrorist financing risks posed by its clients, (2) provide for periodic independent testing of the AML program, (3) designate an AML compliance officer, and (4) provide ongoing AML training for appropriate firm personnel.
- The proposed rule would require registered investment advisers to report suspicious transactions that involve at least \$5,000 in funds or other assets that are conducted or attempted “by, through or at” the adviser. An adviser would be permitted to delegate such responsibilities to an agent or third-party processor, but the adviser would remain liable for any violation by the third party for failure to comply with the suspicious activity reporting requirements.

FinCEN is proposing to delegate its authority to examine registered investment advisers for compliance with these requirements to the SEC. FinCEN notes that it is not proposing a customer identification program requirement at this time, but that it anticipates addressing this issue in a subsequent rulemaking. Comments on the proposed rule were due by November 2, 2015.

The FinCEN proposed rulemaking release is available at: [http://www.fincen.gov/statutes\\_regs/frn/pdf/1506-AB10\\_FinCEN\\_IA\\_NPRM.pdf](http://www.fincen.gov/statutes_regs/frn/pdf/1506-AB10_FinCEN_IA_NPRM.pdf).

## Public Statements, Speeches and Testimony

### SEC Commissioners Address Recent Commission Orders Against CCOs

On August 10, 2015, SEC Commissioner Luis Aguilar released a public statement concerning “the critical importance of clarity in Commission Orders for enforcement actions.” Commissioner Aguilar stated that the Commission and its staff “should always be cognizant that there is a broad audience that carefully reads Commission Orders for guidance” as to what is, and what is not, acceptable behavior. More specifically, Commissioner Aguilar stated that when Commission Orders involve federal securities law violations by Chief Compliance Officers, “[t]he need for clear and transparent Orders is especially important.” Noting that “CCOs, after all, exist in large part to implement and enforce policies and procedures to prevent federal

securities law violations,” Commissioner Aguilar emphasized that “the importance of clarity in Commission Orders, especially the ones involving CCOs, cannot be overstated.”

Along the same lines, SEC Commissioner Daniel Gallagher, in a speech delivered to the U.S. Chamber of Commerce on August 4, 2015 in connection with the fifth anniversary of the enactment of the Dodd-Frank Act, warned that “[r]ecent enforcement actions holding compliance officers to a standard of strict liability will only serve to chill talented professionals from playing this vital role.”

These comments come against a backdrop of other recent comments by SEC Commissioners regarding the appropriate treatment of CCOs in enforcement actions. For instance, on June 18, 2015, Commissioner Gallagher, in a public statement, commented on his vote against two settled SEC enforcement actions (*In the Matter of Blackrock Advisors, LLC and In the Matter of SFX Financial Advisory Management Enterprises, Inc.*) involving alleged violations by CCOs of Rule 206(4)-7 under the Advisers Act, which requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Act. He stated that “[b]oth settlements illustrate a Commission trend toward strict liability for CCOs under Rule 206(4)-7,” suggesting that “[a]ctions like these are undoubtedly sending a troubling message that CCOs should not take ownership of the firm’s compliance policies and procedures, lest they be held accountable for conduct that, under Rule 206(4)-7, is the responsibility of the adviser itself.”

On June 29, 2015, in a public statement titled “The Role of Chief Compliance Officers Must be Supported,” Commissioner Aguilar expressed “concern that the recent public dialogue may have unnecessarily created an environment of unwarranted fear in the CCO community” and that “the dissent [of Commissioner Gallagher] and the resulting publicity, has left the impression that the SEC is taking too harsh of an enforcement stance against CCOs, and that CCOs are needlessly under siege from the SEC.” Commissioner Aguilar insisted that “the Commission does not bring enforcement actions against CCOs who take their jobs seriously and do their jobs competently, diligently, and in good faith to protect investors.” On July 15, 2015, Chair Mary Jo White also weighed in on the public debate in her opening remarks at the SEC’s Compliance Outreach Program for Broker-Dealers. She assured the audience that it is not the Commission’s intention to use its enforcement program to target compliance professionals, stating that “[w]e do not bring cases based on second guessing compliance officers’ good faith judgments, but rather when their actions or inactions cross a clear line that deserve sanction.”

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