Investment Services Regulatory Update

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New Rules, Proposed Rules and Guidance

SEC Issues Concept Release Relating to the Role of Transfer Agents to Mutual Funds

On December 22, 2015, the SEC issued an advanced notice of proposed rulemaking and concept release seeking public comment on a wide range of issues relating to transfer agent regulation. The release identifies certain areas in which the SEC intends to propose specific rules or rule amendments applicable to transfer agents, including with respect to registration and annual reporting requirements, safeguarding funds and securities, antifraud protections and cybersecurity and information technology. Additionally, the concept release seeks public comment on a broader range of issues to better inform the SEC's consideration of additional rulemaking, including, among others, the role of transfer agents to mutual funds based on the unique trading, market, asset class and other relevant characteristics of the mutual funds they service.

The SEC notes that the shift to omnibus account arrangements for mutual fund shareholders has altered the roles and responsibilities of mutual fund transfer agents in traditional shareholder servicing and recordkeeping and, consequently, has led to decreased transparency of beneficial owners and their trading activities and related records. The release also cites the increasingly complex nature of mutual fund transaction processing and compliance responsibilities borne by mutual fund transfer agents in contrast to operating company transfer agents among the reasons for the SEC's request for public comment. The concept release requests comment on the 22 specific topics related to the role of transfer agents to mutual funds, including the following[1]:

- Should the SEC impose additional recordkeeping and disaster recovery requirements for mutual fund transfer agents?
- How are mutual fund transfer agents compensated today? Do any aspects of the structure or terms of their compensation raise regulatory concerns? Do mutual fund transfer agent fees based upon the fund's net assets create any conflicts of interest? Do mutual fund transfer agents provide fee rebates to issuers and, if so, do these raise any issues of regulatory concern?
- How often do mutual fund transfer agents serve as fund administrators for the same mutual fund? Does this dual role create conflicts of interest for either the mutual fund or the mutual fund transfer agents? Does this dual role raise other concerns?
- Should the SEC propose rules governing how mutual fund transfer agents oversee sub-transfer agents to mutual funds?
- What oversight functions, if any, do mutual fund transfer agents typically perform for intermediaries performing sub-transfer agent or sub-accounting services to beneficial owners of mutual fund shares? What are the types of initial versus ongoing due diligence performed? What types of obstacles do mutual fund transfer agents face in performing the oversight function?
- What problems, if any, are created by transfer agents' lack of visibility into the identity of beneficial owners and products serviced by intermediaries acting as sub-transfer agents?

[1] Although the discussion on transfer agents to funds in the release focuses on open-end funds, the SEC also seeks comment on transfer agents to other registered investment companies. For instance, the SEC seeks comment on whether it should address specific issues related to mutual fund transfer agents and transfer agents that service other registered investment companies.

In addition to the specific issues noted above, the SEC invites public comment relating to any other matters that are relevant to the use of transfer agents by mutual funds.

Comments on the release are due on or before February 29, 2016. The release is available at: http://www.sec.gov/rules/concept/2015/34-76743.pdf.

SEC Proposes New Exemptive Rule Governing Funds' Use of Derivatives

On December 11, 2015, the SEC proposed Rule 18f-4 (the "Proposed Rule") under the 1940 Act. If adopted, the Proposed Rule represents a comprehensive overhaul of the current regulatory framework governing the use of derivatives and other trading practices that create leverage by registered investment companies. The Proposed Rule would supersede historical guidance provided by the SEC and its staff.

For a more detailed discussion of the Proposed Rule and its requirements, please see the Vedder Price Newsletter, "SEC Proposes New Rule Governing Funds' Use of Derivatives," published on December 18, 2015 and available at:
http://www.vedderprice.com/SEC-Proposes-New-Rule-Governing-Funds-Use-of-Derivatives/.

The principal elements of the Proposed Rule include the following requirements:

- ***Portfolio Limits.*** A fund must limit its exposure to underlying reference assets through derivatives and other senior securities to either (i) 150% of net assets ("Exposure-Based Portfolio Limit"), or (2) 300% of net assets for funds that satisfy a "value-at-risk" ("VaR") test ("Risk-Based Portfolio Limit").
- ***Asset Coverage.*** A fund must maintain "qualifying coverage assets" in an amount equal to its current obligation (i.e., typically, a mark-to-market amount) plus a cushion, which represents a reasonable estimate of the potential obligations of the fund under stressed conditions.
- ***Risk Management Program.*** Except for funds that use derivatives to a limited extent, the Proposed Rule requires funds to adopt a formalized risk management program and appoint a board-approved derivatives risk manager.

Portfolio Limits

Exposure-Based Portfolio Limit

A fund relying on this limitation generally would be required to limit its aggregate exposure (as defined below), measured immediately after entering into a covered transaction, to 150% of the fund's net assets. Under this test, the Proposed Rule does not include any provision to permit a fund to reduce its aggregate exposure for particular derivatives transactions that may be entered into for hedging (or risk-mitigating) purposes or that may be "cover transactions."

Risk-Based Portfolio Limit

A fund relying on this limitation would be required to limit its aggregate exposure to 300% of the fund's net assets, measured immediately after entering into a covered transaction, if the fund can satisfy a risk-based test based on VaR. To satisfy this test, a fund's full portfolio VaR (i.e., the VaR of its portfolio including derivatives transactions) must be less than that fund's VaR excluding derivatives transactions. The Proposed Rule gives funds some flexibility in the selection of a VaR model for use in the risk-based test for purposes of the risk-based portfolio limit, but the VaR model must meet certain minimum requirements explained in more detail in the Proposed Rule.

Aggregate Exposure

For the purposes of both portfolio limits described above, aggregate exposure is the sum of: (1) the aggregate notional amount of the fund's derivatives transactions, subject to certain adjustments discussed below; (2) the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under any financial commitment transactions; and (3) the aggregate indebtedness (and with respect to any closed-end fund or business development company, involuntary liquidation preference of preferred shares) with respect to any other senior securities transactions entered into by the fund pursuant to Section 18 or 61 of the 1940 Act.

Additionally, the Proposed Rule requires an adjustment to the notional amount in three circumstances: (1) derivatives that provide a return based on the leveraged performance of an underlying reference asset; (2) derivatives transactions for which the underlying reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity; and (3) certain defined "complex derivatives transactions."

Asset Coverage Requirements

Derivatives Transactions

The Proposed Rule would require a fund to manage the risks associated with its "derivatives transactions," which include any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing or any similar instrument that may require payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination. A fund would be required to do so by maintaining a certain amount of "qualifying coverage assets" for each derivatives transaction, determined pursuant to policies and procedures approved by the fund's board of directors. Under the Proposed Rule, "qualifying coverage assets" in respect of a derivatives transaction would be fund assets that either: (1) are cash and cash equivalents; or (2) are, with respect to any derivatives transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset. Notably, qualifying coverage assets do not include other types of liquid assets such as equities or investment grade bonds.

For each derivatives transaction, the Proposed Rule requires a fund to maintain qualifying coverage assets with a value equal to the sum of: (1) the amount that would be payable by the fund if the fund were to exit the derivatives transaction as of the time of determination (the "mark-to-market coverage amount"); and (2) an additional amount that represents a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (the "risk-based coverage amount"). Under the Proposed Rule, the fund must determine the risk-based coverage amount for each derivatives transaction in accordance with policies and procedures approved by the fund's board of directors.

Financial Commitment Transactions

The Proposed Rule would require a fund that engages in "financial commitment transactions" (which include any short sale, reverse repurchase agreement, firm or standby commitment agreement or similar agreement) to maintain qualifying coverage assets equal in value to the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under each of its financial commitment transactions. Under the Proposed Rule, "qualifying coverage assets" in respect of a financial commitment transaction would be fund assets that: (1) are cash and cash equivalents; (2) are, with respect to any financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; or (3) are assets that are convertible to cash or that will generate cash equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors.

Risk Management Program

Funds Subject to the Risk Management Program Condition

Funds that have aggregate exposure to derivatives transactions exceeding 50% of its net asset value, or that use complex derivatives, must adopt and implement a formalized written risk management program. The 50% exposure condition would include exposures from derivatives transactions entered into by a fund, but would not include exposure from financial commitment transactions or other senior securities transactions entered into by the fund pursuant to Section 18 or 61 of the 1940 Act.

Administration of the Program

The Proposed Rule would require a fund to designate an employee or officer of the fund or the fund's investment adviser responsible for administering the policies and procedures of the derivatives risk management program, whose designation must be approved by the fund's board of directors.

Board Approval and Oversight

Under the Proposed Rule, the fund's derivatives risk management program would be administered by the derivatives risk manager, with oversight provided by the fund's board of directors. In addition, the Proposed Rule would require each fund to obtain initial approval of its written derivatives risk management program, and any material changes to the program thereafter, from the fund's board of directors.

Comments on the Proposed Rule are due on or before March 28, 2016. The proposing release is available at: http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

OCIE Issues Risk Alert Regarding Advisers and Funds that Outsource Their CCOs

On November 9, 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert to share its observations and raise awareness of the compliance issues noted by the staff in its examinations of nearly 20 SEC-registered investment advisers and investment companies (collectively, the "registrants") that outsource the role of their chief compliance officers ("CCOs") to unaffiliated third parties.

In conducting these examinations, the staff evaluated the effectiveness of the registrants' compliance programs and outsourced CCOs by considering, among other things, whether: (1) the CCO was administering a compliance environment that addressed and supported the goals of the federal securities laws (i.e., whether compliance risks were appropriately identified, mitigated and managed); (2) the compliance program was reasonably designed to prevent, detect and address violations of the federal securities laws; (3) the compliance program supported open communication between service providers and those with compliance oversight responsibilities; (4) the compliance program appeared to be proactive rather than reactive; (5) the CCO appeared to have sufficient authority to influence adherence to compliance policies and procedures and sufficient resources to perform his or her responsibilities; and (6) compliance appeared to be an important part of the registrant's culture.

The staff noted that an effective outsourced CCO generally: (1) had regular—often in-person—communication with the registrants; (2) had a strong relationship established with the registrants; (3) had sufficient registrant support; (4) had sufficient access to registrants' documents and information; and (5) had knowledge about the regulatory requirements and the registrants' business.

The staff also offered a number of specific observations based on the examinations:

- **Meaningful Risk Assessments:** The staff noted that certain outsourced CCOs used questionnaires or standardized checklists that failed to fully capture the business models, practices, strategies and compliance risks that were applicable to the registrant. In addition, the staff observed that some outsourced CCOs did not appear sufficiently knowledgeable to identify or pursue incorrect or inconsistent information about the registrants' business practices found in questionnaire responses. Finally, the staff noted that several registrants did not appear to have sufficient policies and procedures to address conflicts of interest in critical areas such as compensation, valuation, brokerage/execution and personal securities transactions.
- **Compliance Policies and Procedures:** The staff observed certain instances in which compliance policies and procedures were not followed or the registrants' actual practices were not consistent

with the description in the registrants' compliance manuals. These practices were observed in areas that are required to be reviewed by regulations and in areas that registrants included in their policies and procedures, but that are not expressly required to be reviewed by regulations. The Risk Alert states that in many instances the outsourced CCOs were designated as the individuals responsible for conducting the reviews. The staff also observed that several of the compliance manuals reviewed during the course of the examinations were created using outsourced CCO-provided templates, not tailored to the registrants' businesses and practices and containing policies and procedures not appropriate or applicable to the registrants' businesses or practices.

- **Annual Review of the Compliance Programs:** The staff observed a general lack of documentation evidencing the outsourced CCOs' annual reviews, including testing for compliance with existing policies and procedures. The staff also noted that certain outsourced CCOs infrequently visited registrants' offices and conducted only limited reviews of documents or training on compliance-related matters while on-site, leading to limited visibility and prominence and resulting in limited authority to improve adherence to the registrants' compliance policies and procedures or implement important changes in disclosure.

The staff concluded the Risk Alert with a suggestion to registrants with outsourced compliance functions to review their business practices in light of the risks noted to determine whether these practices comport with the registrants' responsibilities as set forth in Rule 206(4)-7 under the Advisers Act and Rule 38a-1 under the 1940 Act.

The Risk Alert is available at:
https://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf.

Litigation and Enforcement Actions

FINRA Sanctions Barclays Capital for Unsuitable Mutual Fund Transactions and Related Supervisory Failures

On December 29, 2015, Barclays Capital, Inc. ("Barclays") entered into a Letter of Acceptance, Waiver and Consent (the "AWC") with FINRA to settle alleged mutual fund-related suitability violations and related supervisory failures, as well as alleged failures to provide applicable breakpoint discounts to certain customers.

FINRA alleged that, for a period of at least five years, Barclays had inadequate systems and written procedures for supervising the sale of mutual funds to retail brokerage customers. In particular, the AWC alleges that Barclays: (1) failed to provide adequate supervisory guidance for ensuring the suitability of mutual fund transactions; (2) incorrectly defined a mutual fund "switch;" (3) failed to identify unsuitable mutual fund transactions, including but not limited to switches; (4) failed to notify customers of the costs associated with switches; and (5) failed to have a centralized system in place to aggregate mutual fund purchases to ensure customers received available mutual fund breakpoint discounts. The AWC cites NASD Notices to Member 94-16 and 95-80 which remind broker-dealers of their obligation to ensure that any recommendation to switch mutual funds be evaluated with regard to the net investment advantage to the investor. FINRA noted that "[s]witching among certain fund types may be difficult to justify if the financial gain or investment objective to be achieved by the switch is undermined by the transaction fees associated with the switch." FINRA alleged that from January 2010 through March 2015, Barclays' written compliance policies and supervisory procedures for its retail brokerage business incorrectly defined a mutual fund switch to require three separate mutual fund transactions within a particular time frame and thus, were not sufficient to prevent unsuitable switching resulting in customer harm of approximately $8.63 million.

The AWC alleges that, as a result of its conduct, Barclays violated NASD Rules 2310(a) and 3010(a) and (b) and FINRA Rules 2010, 2111(a) and 3110(a) and (b). Barclays neither admitted nor denied the charges, but consented to the entry of FINRA's findings and the imposition of sanctions, including, among other things, a censure, a fine of $3.75 million and restitution, including interest, of over $10 million.

The AWC is available at: http://www.finra.org/sites/default/files/Barclays_AWC_122915.pdf.

SEC Settles Charges against Wealth Management Businesses for Failing to Disclose Conflicts of Interest Arising from Preferences for Proprietary Funds

On December 18, 2015, the SEC announced settled administrative proceedings against J.P. Morgan Securities LLC ("JPMS") and JPMorgan Chase Bank, N.A. ("JPMCB"), the wealth management businesses of JPMorgan Chase & Co. ("JPMorgan"), for failing to disclose conflicts of interest arising from preferences for JPMorgan-managed mutual funds ("Proprietary Mutual Funds"), JPMorgan-managed hedge funds and third-party-managed hedge funds that shared client fees with a JPMorgan affiliate.

According to the SEC's order, from May 2008 to 2013, JPMS failed to disclose: (1) its preference for Proprietary Mutual Funds for retail investors in Chase Strategic Portfolio ("CSP"), a retail unified managed account program; (2) that the availability and pricing of services provided to JPMS by an affiliate was tied to the amount of CSP assets that JPMS invested in Proprietary Mutual Funds; and (3) that certain Proprietary Mutual Funds offered a less-expensive share class, but would generate less revenue for a JPMS affiliate, than the share class that JPMS chose for CSP clients. The SEC also stated that JPMS did not implement its written policies and procedures to ensure adequate disclosure of the conflicts of interest addressed in the order. In addition, the SEC's order found that, among other things, from February 2011 until January 2014, JPMCB did not disclose a preference for Proprietary Mutual Funds in account documentation for its high net worth clients serviced through J.P. Morgan Private Bank.

The SEC's order found that JPMS violated Sections 206(2), 206(4) and 207 of the Advisers Act and Rule

206(4)-7 thereunder, and JPMCB violated Sections 17(a)(2) and 17(a)(3) of the Securities Act. JPMS and JPMCB admitted the facts set forth in the SEC's order and acknowledged that the conduct violated federal securities laws. The JPMorgan subsidiaries agreed to pay $127.5 million in disgorgement, $11.815 million in prejudgment interest, and a $127.5 million penalty. JPMS agreed to be censured, and both subsidiaries agreed to cease and desist from further violations.

The SEC order is available at: https://www.sec.gov/litigation/admin/2015/33-9992.pdf.

SEC Settles with Investment Adviser over False Performance Claims

On November 16, 2015, the SEC announced settled administrative proceedings against Virtus Investment Advisers, Inc. ("Virtus"), a registered investment adviser that operates as a "manager of managers," for publishing advertisements that contained untrue statements of material fact and for failing to adopt and implement reasonably designed policies and procedures regarding the retention of books and records necessary to support the basis for performance obtained by other advisers or sub-advisers in advertisements directly or indirectly distributed by Virtus. According to the SEC's order, the matter stemmed from Virtus's engagement in 2009 of an unaffiliated registered investment adviser, F-Squared Investments, Inc. ("F-Squared"), to sub-advise certain Virtus-advised mutual funds based on F-Squared's AlphaSector strategy, which employed a signaling algorithm to rebalance a portfolio of exchange-traded funds and was also used for certain separately managed accounts advised by Virtus. F-Squared's own advertising of the AlphaSector strategy was described by the SEC as "materially inflated, and hypothetical and back-tested," in a separate SEC enforcement order concerning F-Squared in December 2014, although F Squared advertised the investment strategy as "not back-tested."

According to the SEC, from May 2009 to September 2013, in certain client presentations, marketing materials, SEC filings and other communications, Virtus falsely stated that (1) the AlphaSector strategy had a history that dated back to April 2001 and had been in use since then, and (2) the strategy had significantly outperformed the S&P 500 Index from April 2001 to September 2008. However, the SEC alleged, no F-Squared or other client assets tracked the strategy from April 2001 to September 2008. In addition, the order states that the hypothetical and back-tested track record of AlphaSector from April 2001 to September 2008 was substantially inflated, a result of F-Squared incorrectly implementing signals in advance of when such signals actually could have occurred. (The SEC's December 2014 order concerning F-Squared indicated that virtually all of AlphaSector's claimed outperformance relative to the S&P 500 Index for the pre-October 2008 period was attributable to the data compilation error, which, the SEC alleged, was ignored by F-Squared and its principal.)

Virtus consented to the entry of the order finding that it violated Sections 204, 206(2) and 206(4) of the Advisers Act and Rules 204-2(a)(16), 206(4)-1(a)(5), 206(4)-7 and 206(4)-8 thereunder. The order also finds that Virtus caused certain mutual funds that it advised to violate Section 34(b) of the 1940 Act. Without admitting or denying the findings, Virtus agreed to pay $13.4 million in disgorgement, $1.1 million in prejudgment interest and a $2 million penalty.

The SEC order is available at: http://www.sec.gov/litigation/admin/2015/ia-4266.pdf.

U.S. District Court Grants Defendants' Motion to Dismiss in PIMCO Case Relating to Violation of Investment Policies

In January 2015, William T. Hampton, on behalf of himself and other shareholders of the PIMCO Total Return Fund, filed a shareholder class action lawsuit against Pacific Investment Management Company, LLC ("PIMCO"), PIMCO Funds, a Massachusetts business trust, and seven trustees of PIMCO Funds. The plaintiff's initial complaint alleged a violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder based on an allegation that the Fund, for which PIMCO serves as investment adviser, invested in derivative instruments beyond a limit set forth in the Fund's prospectus. The plaintiff alleged that, as a result of the deviation from the Fund's investment restrictions, the value of the Fund's shares fell.

In July 2015, the plaintiff filed an amended complaint that replaced the claim under Section 10(b) and Rule 10b-5 with a number of state law claims, similar to those alleged by the plaintiffs in the recently decided Northstar Financial Advisors, Inc. v. Schwab Investments case, based on breach of contract, breach of trust and breach of the implied covenant of good faith and fair dealing. These claims all related to an allegation that, between early 2012 and September 2014, the Fund violated an investment restriction set forth in its prospectus by investing more than 15% of its assets in securities and other instruments tied to emerging markets, causing the value of the Fund's shares to fall. In September 2014, the Fund changed the 15% policy without a shareholder vote.

On October 5, 2015, the defendants filed a motion to dismiss each of the plaintiff's claims. The defendants argued that all of the plaintiff's claims should be precluded by the Securities Litigation Uniform Standards Act ("SLUSA"), which prohibits private "covered class action" lawsuits (i.e., class actions seeking damages on behalf of more than 50 plaintiffs) that are based on state law claims alleging either a material misrepresentation or omission or the use of manipulation or deception in connection with the purchase or sale of a "covered security" (i.e., a security listed on a national securities exchange or issued by a registered investment company).

On November 2, 2015, the U.S. District Court for the Central District of California granted the defendants' motion to dismiss all of the plaintiff's claims, agreeing with the defendants that SLUSA applied to preclude all of the plaintiff's claims.

The parties agreed that the case was a covered class action and involved a covered security under SLUSA. The District Court determined that the plaintiff's claims were all essentially misrepresentation claims—the defendants promised to do one thing in the Fund's prospectus but instead did another, resulting in harm to the putative class members. The District Court noted that SLUSA precludes a variety of state law claims because they are based on misrepresentation, and that "[m]isrepresentation need not be a specific element of the claim to fall within [SLUSA]'s preclusion." The District Court also determined that the plaintiff's claims all involved activity "in connection with" the purchase or sale of a security, noting that the U.S. Supreme Court has instructed courts to apply this element of SLUSA "broadly," and that it is satisfied if the alleged fraud relates merely "to the nature of the securities, the risks associated with their purchase or sale, or some other factor with similar connection to the securities themselves."

Finally, the District Court concluded that a SLUSA provision commonly referred to as the "Delaware carve-out" did not apply to the plaintiff's claims. This carve-out applies when (1) state law claims are brought under the law of the state in which the issuer is organized and (2) the claims are part of an action involving either (a) the purchase or sale of securities by the issuer or its affiliate exclusively from or to holders of the issuer's equity securities or (b) any recommendation, position or other communication with respect to the sale of the issuer's securities made by or on behalf of the issuer or its affiliate to holders of the issuer's equity securities that concerns decisions of those holders with respect to voting their securities, responding to a tender or exchange offer or exercising dissenters' or appraisal rights. The first prong of this carve-out was met because the claims were brought under Massachusetts law. The plaintiff argued that the second prong should be met because shareholders should have been able to vote on changing the Fund's 15% investment restriction. The District Court disagreed, concluding that the second prong was not satisfied because there was no shareholder vote.

In dismissing the plaintiff's claims, the District Court frequently cited the recent decision in the Northstar case, a shareholder class action lawsuit in which the U.S. District Court for the Northern District of California concluded that SLUSA applied to preclude several similar state law contract claims based on misrepresentations in a fund's proxy statement and prospectus.

On November 30, 2015, the plaintiff filed a notice of appeal of the District Court decision with the Ninth Circuit Court of Appeals.

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." 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)" 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 semiannual 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 all such claims 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 reassert 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 reassert 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 byproduct 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.

Other News and Developments

SEC Launches Sweep of High-Yield Bond Funds

On December 18, 2015, *Board IQ* reported that the SEC launched a sweep of high-yield bond funds requesting “dozens of pieces of information, some of which the SEC demanded to be produced within 24 to 48 hours.” The data, information and materials identified in the article as requested by the SEC “for immediate production” includes: a description of each high-yield bond fund, its securities, pricing source, market value, external and internal bond rating, liquidity status, daily liquidity fund calculations, the definition of the methodology used to determine if the securities were liquid, large shareholders, price challenges, flows, redemption activities, all disclosures in the past six months concerning liquidity, policies and procedures related to liquidity risk, the most recent annual report submitted to the board by the CCO, the names of independent directors who have resigned or were terminated between midsummer and mid-December, and the reasons for their departure. *Board IQ* also reported that the SEC requested, for subsequent production, “all board meeting materials for the year, the most recent annual assessment by the fund board, minutes of board meetings and the minutes of independent director meetings.”

ICI and IDC Survey Shows Fund Boards Follow Strong Governance Practices

On October 27, 2015, the Investment Company Institute (ICI) and Independent Directors Council (IDC) released a biennial update to a joint publication, Overview of Fund Governance Practices, 1994-2014. The guidance is based on data gathered from fund complexes and provides an overview of common fund governance practices. The results of the survey, according to the ICI and IDC, show that fund boards follow strong governance practices and adopt such practices in advance of, or in the absence of, any regulatory mandate to do so. Certain key findings from the survey include (as of year-end 2014) the following:

- Independent directors hold 75% or more of board seats in 83% of participating complexes, an increase from 46% in 1996;
- 65% of participating complexes reported having boards with an independent board chair and, when complexes that have boards with independent lead directors are also considered, 89% of participating complexes reported having an independent director in a board leadership role;
- 92% of participating complexes reported that independent directors are represented either by dedicated counsel or counsel separate from the adviser, an increase from 64% in 1998; and
- 97% of participating complexes reported having an audit committee financial expert although current rules require only that funds disclose whether the audit committee includes a financial expert.

In a statement announcing the survey results, the ICI and IDC stated that during the 20 years in which survey data has been taken, fund boards have been implementing practices that surpass existing legal requirements.

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