Investment Services Regulatory Update

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VedderPrice℠

New Rules, Proposed Rules and Guidance

Division of Investment Management Issues Guidance on Oversight of Distribution Fees and Intermediary Payments

On January 6, 2016, the staff of the SEC's Division of Investment Management issued a Guidance Update outlining the staff's views and recommendations regarding oversight of mutual fund distribution fees and the payment of fees to financial intermediaries characterized as non-distribution related to sub-transfer agent, administrative, sub-accounting and other shareholder servicing fees (collectively, "sub-accounting fees").

The Guidance Update follows sweep examinations conducted by the SEC's Office of Compliance Inspections and Examinations to assess whether mutual fund payments to financial intermediaries constitute "distribution-in-guise." That is, whether some or all of the payments characterized as sub-accounting fees were, in fact, for distribution-related services, paid out of fund assets, but not pursuant to a Rule 12b-1 plan and thus, impermissible under the 1940 Act. Rule 12b-1 prohibits mutual funds from engaging, directly or indirectly, in the financing of any activity which is primarily intended to result in the sale of fund shares except pursuant to a written plan that meets the requirements of Rule 12b-1.

In the Guidance Update, the staff's broad recommendations include:

- whether or not a fund has a 12b-1 plan, the fund's board should have a process in place reasonably designed to evaluate whether a portion of sub-accounting fees is being used to pay directly or indirectly for distribution;
- as part of this process, advisers and other relevant service providers should provide sufficient information to inform the board of the "overall picture" of the fund's distribution and servicing arrangements, including how the level of sub-accounting fees may affect other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution; and
- advisers and other relevant service providers should inform boards if certain activities that are potentially distribution-related exist in connection with sub-accounting fee arrangements, and if they do, boards should evaluate the appropriateness and character of those payments with heightened attention.

In addressing how a board may seek to appropriately characterize fees, the staff cites the 1998 letter from the SEC staff to the Investment Company Institute regarding mutual fund supermarket fees (commonly referred to as the "supermarket letter"), noting that the same types of factors and analysis described in the supermarket letter may serve as a useful framework for the board's process. In addition, the staff noted that boards might generally consider also requesting relevant additional information from the adviser and other service providers, including:

i. information about the specific services provided under the mutual fund's sub-accounting agreements;

ii. the amounts being paid;

iii. if the adviser and other service providers are recommending any changes to the fee structure or if any of the services provided have materially changed;

iv. whether any of the services could have direct or indirect distribution benefits;

v. how the adviser and other service providers ensure that the fees are reasonable; and

vi. how the board evaluates the quality of services being delivered to beneficial owners (to the extent of its ability to do so).

Regardless of the specific process employed to make an evaluation of fees, the SEC staff recommends that boards have a process in place reasonably designed to provide them enough information that they can make an informed judgment as to whether fund-paid fees are being used to pay directly or indirectly for distribution, noting that there are “a number of reasonable approaches” but, “in the absence of any such process, it is unclear how a board might make an informed judgment” regarding the fund’s compliance with Rule 12b-1. Notably, the SEC staff suggested that funds should have “explicit policies and procedures as part of their Rule 38a-1 compliance programs designed to prevent violations of Section 12(b) and Rule 12b-1.” In this regard, the Guidance Update states that, as part of the distribution-in-guise sweep exams, the staff observed that many funds did not have such “explicit policies and procedures.”

Other staff observations from the sweep exams are noted in the Guidance Update as indicia that may raise concerns that a payment, though ostensibly not for distribution-related activities, may in fact be (at least in part) a payment for such services. These situations or arrangements include:

- distribution-related activity is conditioned on the payment of a sub-accounting fee;
- a fund has not adopted a 12b-1 plan and does not impose sales loads;
- a fund uses a tiered payment structure for a number of services in which intermediaries are paid first from Rule 12b-1 fees, then fund-paid sub-accounting fees and finally any balance is paid by the adviser or an affiliate from revenue sharing, raising the question of what services the fund is actually paying for and whether any fund-paid fees reduce or subsidize fees that the adviser or other service provider might otherwise be responsible for;
- there is a lack of specificity of services provided by an intermediary or payments for both sub-accounting and distribution have been bundled into a single contract. As to this particular circumstance, the staff noted that, in some cases, boards have evaluated whether the *overall payment* for a bundled set of services or activities is a payment that is primarily for distribution-related services, an approach that is, in the staff’s view, “inconsistent with the requirements of Rule 12b-1, which explicitly requires that any *activity* which is primarily intended to result in the sale of mutual fund shares be paid for through a 12b-1 plan, if paid from mutual fund assets.”
- the adviser and other service providers take into account distribution and sales benefits when recommending, instituting, or raising sub-accounting fees;
- there are large disparities in the sub-accounting fee rates to intermediaries providing substantially the same set of services to the fund; and

- intermediaries sell additional "strategic sales data" to funds, their adviser or other service providers, providing information about fund investor demographics and other information about top sales partners and channels.

Recognizing that boards are typically not involved in the negotiation of agreements with intermediaries, the SEC staff maintains that boards should be able to rely on the adviser and other service providers "to affirmatively provide information about the existence of any of these activities or arrangements, as well as summary data about expenses and activities related to distribution-related activities." In addition, the SEC staff notes its expectation that fund directors can receive and rely on the assistance of outside counsel, the fund's chief compliance officer, or personnel of the adviser or relevant service providers, as appropriate, to assist them in evaluating payments to intermediaries. In the staff's view, the board's role should "focus on understanding the overall distribution process as a whole to inform its reasonable business judgment about whether sub-accounting and other mutual fund-paid fees represent payments for distribution, in whole or in part."

The Guidance Update is available at: https://www.sec.gov/investment/im-guidance-2016-01.pdf.

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, anti-fraud 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

[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.

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?

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.

Public Statements Press Releases and Testimony

OCIE Announces 2016 Exam Priorities

The SEC's Office of Compliance Inspections and Examinations ("OCIE") recently announced its 2016 examination priorities for regulated entities, including registered funds and investment advisers. The examination priorities are organized into the same three broad categories as last year: (1) matters of importance to retail investors, including investors saving for retirement; (2) issues related to market-wide risks; and (3) use of data analytics to identify potential illegal activities. Within these groupings are several issues of potential interest to registered funds and their investment advisers, including the following:

ETFs: OCIE will examine ETFs for compliance with applicable exemptive relief granted under the Exchange Act and the 1940 Act and with other regulatory requirements, as well as review the ETFs' unit creation and redemption process. OCIE also stated its intent to evaluate ETF sales strategies, trading practices, and disclosures, including "excessive portfolio concentration, primary and secondary market trading risks, adequacy of risk disclosure, and suitability, particularly in niche or leveraged/inverse ETFs."

Cybersecurity: Noting its recent initiatives to examine cybersecurity compliance and controls, OCIE will continue these efforts by testing and assessing firms' implementation of cybersecurity procedures and controls. Throughout the past year, the SEC has devoted a significant amount of attention to identifying risks in the area of cybersecurity, including releasing cybersecurity guidance and publishing summary observations of findings from a series of cybersecurity examinations.

Liquidity Controls: In light of changes in fixed income markets over the past several years, OCIE will examine investment advisers to mutual funds, ETFs and private funds that have exposure to potentially illiquid fixed income securities and evaluate, among other things, risk management, valuation, liquidity management and trading activity.

Never-Before-Examined Investment Advisers and Investment Companies: OCIE will continue conducting "focused, risk-based examinations" of investment advisers and fund complexes that have not yet been examined.

This list of examination priorities is not exhaustive and OCIE may adjust the priorities in light of market conditions, industry developments and ongoing risk assessment activities.

The examination priorities are available at:
https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2016.pdf.

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

On November 9, 2015, 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

Sivolella 36(b) Excessive Fee Case: First to Trial Since 2009

The trial phase of Sivolella v. AXA Equitable Life Insurance Co., originally filed in 2011 and the first Section 36(b) "excessive fee" case to proceed to trial since 2009, has commenced in the U.S. District Court, District of New Jersey, before Judge Peter G. Sheridan. Section 36(b) of the 1940 Act imposes a "fiduciary duty [on investment advisers] with respect to the receipt of compensation for services" and provides shareholders with a private right of action to enforce this obligation by seeking judicial review of fees charged by investment advisers under a breach of fiduciary duty standard. In Sivolella, the plaintiffs, variable annuity program participants for which the separate account invested in EQ Advisors Trust funds, alleged that the investment adviser's fees were excessive because it delegated virtually all of its duties to sub-advisers and sub-administrators, but retained a disproportionate amount of the total advisory fees paid by the funds. The non-jury trial is expected to last into February.

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.

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."

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

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