VedderPrice

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Investment Services Regulatory Update

Litigation and Enforcement Actions

PIMCO Settles Charges of Misleading Investors Regarding ETF Performance

On December 1, 2016, the Securities and Exchange Commission (SEC) announced settled administrative proceedings against Pacific Investment Management Company LLC (PIMCO), a registered investment adviser, for misleading investors about the performance of its PIMCO Total Return Exchange-Traded Fund (the Fund), overstating the Fund's net asset value (NAV) and, consequently, executing shareholder transactions at prices not based on current net asset values.

According to the SEC's order, to help increase the Fund's initial performance after its launch on February 29, 2012, PIMCO used a strategy that involved purchasing odd lot positions (i.e., small-sized pieces) of non-agency mortgage-backed securities (NA MBS) that traded at discounts to round lot positions (i.e., institutional, larger-sized pieces having at least $1 million current face value) and then valuing those positions for purposes of calculating the Fund's NAV at higher round lot evaluated prices (the Pricing Vendor Marks) provided by a third-party pricing service (the Pricing Vendor). The SEC order states that PIMCO continued to use this "odd lot" strategy through June 30, 2012 (the Relevant Period) and purchased 156 odd lot NA MBS at discounted odd lot prices that it valued at the higher Pricing Vendor Marks for purposes of calculating the Fund's NAV. In this regard, the SEC alleged that throughout the Relevant Period, PIMCO calculated and published an overstated daily NAV for the Fund based on valuations that took advantage of the difference between odd lot and round lot pricing. The SEC order states that for 43 of the NA MBS positions, PIMCO did not have a "reasonable basis to believe that the Pricing Vendor Mark accurately reflected the exit price [the Fund] would receive for those positions."

The SEC order alleges that there were numerous variance notifications from the Fund's administrator that the Pricing Vendor Marks used to value the NA MBS positions may not have reflected fair value under Section 2(a)(41) of the 1940 Act and notes that despite the notifications, the traders responsible for the trades did not challenge the Pricing Vendor Marks. The SEC order further states that PIMCO's pricing policies and procedures were not reasonably designed to consider odd lot pricing generally and failed to provide sufficient oversight of the traders' determinations regarding price or guidance regarding when a trader should elevate significant pricing issues, such as odd lot pricing, to PIMCO's Pricing Committee or the Valuation Committee of the Fund's Board of Trustees (the Board). The order also states that individuals, other than the traders, at PIMCO were aware of the odd lot pricing and its potential impact on the Fund's NAV but failed to test the Fund's odd lot pricing methodology to determine whether the use of round lot prices for the NA MBS positions appropriately reflected fair value for these smaller positions.

In addition, the SEC alleged that PIMCO negligently provided disclosures, in monthly and annual reports to investors, that were misleading regarding the reasons for the Fund's performance, including the Fund's outperformance versus the PIMCO Total Return Fund, PIMCO's flagship mutual fund. The SEC order states that PIMCO failed to disclose the impact of the "odd lot" strategy and that the performance resulting from this strategy would not be sustainable as the Fund grew in size, and instead attributed the Fund's exceptional performance to the non-agency sector in general and prices for NA MBS that "rose." The SEC stated that these disclosures implied that the Fund's performance resulted from price appreciation in the non-agency sector, despite internal reports indicating that a significant portion of the Fund's performance was due to gains from valuing odd lots at the Pricing Vendor Mark. In addition, the order states that PIMCO failed to disclose the existence or impact of the "odd lot" strategy to the Board when they specifically inquired as to the Fund's outperformance versus the Total Return Fund.

As a result of the foregoing conduct, the SEC found that PIMCO violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder. The SEC also found that PIMCO violated Section 34(b) of the 1940 Act and Rule 22c-1 thereunder. Pursuant to the terms of the order, PIMCO agreed to retain an Independent Compliance Consultant to conduct a comprehensive review of PIMCO's written compliance policies and procedures and to adopt any of the recommended changes or improvements that result from its review. In addition, PIMCO was censured and agreed to pay a civil money penalty of $18.3 million, as well as $1.3 million in disgorgement, plus interest of approximately $198,000, and agreed to cease and desist from any violations (and future violations) of the laws violated by the foregoing conduct.

The SEC order is available at: https://www.sec.gov/litigation/admin/2016/ia-4577.pdf

U.S. District Court Orders Trustees to Produce Documents Redacted or Withheld Under Attorney-Client Privilege in Mutual Fund Excessive Fee Litigation

On November 21, 2016, the U.S. District Court for the Western District of Washington issued an order (the Order) granting a plaintiff's motion to compel certain independent trustees of the PIMCO Total Return Fund (the Fund) to produce documents redacted or withheld under the attorney-client privilege in connection with a mutual fund "excessive fee" case, agreeing with the plaintiff's argument that a "fiduciary exception" to the attorney-client privilege should apply. The independent trustees, who are not a party to the litigation, and defendants Pacific Investment Management Company LLC and PIMCO Investments LLC (collectively, PIMCO or the Defendants) each opposed the motion by the plaintiff, a shareholder of the Fund who alleged that PIMCO breached their fiduciary duty owed to the Fund's shareholders pursuant to Section 36(b) of the 1940 Act by charging the Fund excessive fees.

On November 30, 2015, the plaintiff issued non-party document subpoenas to the Fund's independent trustees. In response, the independent trustees redacted and withheld over 200 documents in reliance on the attorney-client privilege. The Order indicates that the documents that had been withheld by the independent trustees on the basis of the attorney-client privilege included, among other things, communications relating to confidential legal advice regarding the annual review and approval of the Fund's advisory agreement, administration agreement and distribution and servicing plan. Thereafter, the plaintiff filed a motion to compel disclosure of those documents, arguing that a "fiduciary exception" to the privilege should apply.

The attorney-client privilege gives a client the right to maintain the confidentiality of communications between the client and his or her attorney relating to the provision of legal advice; the intention of the privilege is "to encourage full and frank communication between attorneys and their clients in the observance of law and administration of justice." The fiduciary exception to the attorney-client privilege derives from trust law and prohibits the privilege from being used to withhold information from the beneficiary of a trust when a trustee seeks or receives legal advice in connection with his or her administration of the trust; for the privilege to apply to communications between a trustee and his or her attorney, the trustee must show that he or she obtained legal advice for personal protection or otherwise for an individual personal purpose. The fiduciary exception is intended to ensure full disclosure in the trustee-beneficiary relationship, which courts have viewed as "ultimately more important than the protection of the trustees' confidence in the attorney for the trust."

In arguing for the application of the fiduciary exception, the plaintiff pointed out that the Fund is a series of PIMCO Funds Trust, a Massachusetts business trust; that the independent trustees have fiduciary duties under state and federal law; and that the communications at issue were provided to the trustees in their role as fiduciaries and related to the administration of the trust. Defendants and the independent trustees argued that the exception should not apply, pointing out that the exception has never been applied in mutual fund litigation and arguing that the application of the exception could have a chilling effect on communications between independent trustees of funds and their counsel.

In issuing the Order, the Court agreed with the plaintiff's argument that the fiduciary exception to the attorney-client privilege should apply. The Court explained that the Fund is a series of a trust, that the independent trustees "clearly owed a fiduciary duty to Plaintiff and other shareholders," that the documents at issue relate to legal advice provided in connection with managing the Fund rather than personal advice to the trustees and that the communications were not made in anticipation of litigation.

The Order was issued in the case *Kenny v. Pacific Investment Management Company LLC et al.*, Case No. C14-1987-RSM.

SEC Overturns Administrative Law Judge's Decision and Finds Adviser Failed to Disclose Material Conflicts of Interest Relating to Revenue Sharing Arrangement

On November 7, 2016, the Securities and Exchange Commission (SEC), on appeal by the Division of Enforcement, overturned an administrative law judge's (ALJ) dismissal of an enforcement proceeding and voted to impose civil money penalties against The Robare Group Ltd. (the Firm), a registered investment adviser, and two of its principals (collectively with the Firm, the Respondents) for failing to adequately disclose material conflicts of interest associated with an arrangement whereby the Firm received compensation from Fidelity Investments (Fidelity), the custodian of its client accounts, for maintaining client assets in certain mutual funds offered on the Fidelity platform. Although the SEC agreed with the ALJ that the Respondents did not act with scienter, the SEC reached a different conclusion on the Respondents' alleged negligence, finding that because the Respondents negligently failed to fully and fairly disclose a material conflict of interest, their conduct "operate[d] as a fraud or deceit upon [their] client[s]" and violated Section 206(2) of the Advisers Act. The SEC also found that the Respondents made material misrepresentations and omissions on Form ADV, thus violating Section 207 of the Advisers Act.

The SEC's opinion states that the Firm offers its clients a number of model portfolios consisting almost entirely of non-transaction fee (NTF) mutual funds offered on Fidelity's online platform. According to the opinion, in early 2004, the Firm entered into a revenue sharing arrangement with Fidelity (the Arrangement), pursuant to which Fidelity paid the Firm "shareholder servicing fees" between two and twelve basis points, based on the value of eligible assets under management, when its clients invested in certain eligible non-Fidelity, NTF mutual funds. The opinion states that under the terms of the agreement with Fidelity, the Firm was responsible for reviewing and determining whether additional disclosure regarding the

Arrangement was necessary in the Firm's Form ADV. However, the SEC found that the Firm's Form ADV did not adequately disclose the Arrangement until at least April 2014. In this regard, the SEC cited the form requirement that an adviser "describe the arrangements" whereby the firm or related persons were given "cash…or…some economic benefit…from a non-client in connection with giving advice to clients," and found, for instance, the Firm's March 2005 ADV disclosure that its representatives "may sell securities…for sales commissions" to be inadequate. The SEC stated that the foregoing "boilerplate" disclosure about possible sales commissions and selling compensation did not constitute the "full and fair" disclosure that the law requires; specifically, the disclosure was inaccurate since the compensation that the Firm received under the Arrangement was not a sales commission and was not paid per transaction. Consequently, the SEC alleged the disclosure about possible compensation based on sales in the Form ADV could not alert clients to the actual source of the conflict of interest – that the Firm had a financial incentive to maintain client assets in certain mutual funds. Notably, the SEC asserted that, regardless of the nature and/or type of compensation received, the Firm's disclosure that it *may* receive selling compensation in the form of 12b-1 fees "in no way revealed" that the Firm actually had an arrangement with Fidelity, that it received compensation thereunder and that the arrangement presented at least a potential conflict of interest.

Subsequent Form ADV disclosure by the Firm was also found to be insufficient, even though it identified Fidelity as the source of compensation and provided "an abbreviated description of the basis for the payments." In this connection, the SEC asserted that the disclosure failed to explain that the Firm received compensation based on its selection of certain NTF mutual funds over others. The SEC also rejected the Respondents' contention that they adequately disclosed the Arrangement to its clients by means other than its Form ADV, including the Fidelity custody agreement (the Agreement) which the Firm gave clients when they opened their accounts. The SEC raised two objections: first, that a large proportion of the Firm's clients never received the relevant version of the Agreement and second, that the Agreement did not provide adequate disclosure even for those clients that received it. As to the latter point, the opinion cites a statement by Fidelity in the Agreement that Fidelity "may pay your advisor for performing certain back-office, administrative, custodial support, and clerical services for [Fidelity] in connection with client accounts for which [Fidelity] act[s] as custodian," and that "[t]hese payments may create an incentive for your adviser to favor certain types of investments over others." The foregoing disclosure was inadequate, according to the SEC, because it failed to state that the Firm had, in fact, entered into an agreement with Fidelity to receive these payments.

In finding that the Respondents failed to exercise reasonable care and thus, acted negligently in failing to adequately disclose the Arrangement, the SEC rejected the Respondents' contention that they relied on others, including compliance consultants, about how to disclose the Arrangement. Contrary to the ALJ, which was persuaded that the Respondents sought advice from "experienced and competent compliance consultants" and relied in good faith on such advice, the SEC asserted that neither the Respondents nor the ALJ cited any case recognizing a defense of reliance on compliance consultants and that, in any event, no evidence exists that the Firm specifically sought or received advice about how to disclose the Arrangement to its clients.

Given the findings that the Respondents violated Sections 206(2) and 207 of the Advisers Act and in light of the factors considered, the SEC imposed a cease-and-desist order and a total of $150,000 in civil money penalties against the Respondents.

Commissioner Piwowar concurred with the opinion but dissented on the imposition of civil penalties, believing that five of the six statutory factors relevant to determining whether a penalty should be assessed weighed against imposing any penalty.

The Opinion is available at: https://www.sec.gov/litigation/opinions/2016/ia-4566.pdf.

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Investment Services Group

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