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Investment Services Regulatory Update

Litigation and Enforcement Actions

U.S. District Court Denies Plaintiffs' Motion to Compel Production of Documents Subject to Attorney-Client Privilege in Mutual Fund Excessive Fee Litigation

On April 25, 2017, the U.S. District Court for the Northern District of Illinois issued an order (the Order) denying the plaintiffs' motion to compel Calamos Investment Trust, a Massachusetts business trust (the Trust), and its Independent Trustees to produce certain documents redacted or withheld under the attorney-client privilege in connection with pending litigation against Calamos Advisors LLC and Calamos Financial Services LLC (collectively, Calamos or the Defendants). The plaintiffs, shareholders of the Calamos Growth Fund, a series of the Trust, who have alleged that Calamos breached its fiduciary duty under Section 36(b) of the 1940 Act by charging excessive advisory and distribution fees to the Fund, argued that, although the documents in question may be subject to the attorney-client privilege, a "fiduciary exception" to the privilege should apply to allow the plaintiffs to gain access to the documents. The Trust and the Independent Trustees, who are not parties to the litigation, opposed the motion.

In connection with the Section 36(b) case against Calamos, plaintiffs issued subpoenas requesting production of certain documents from the Trust and the Independent Trustees. In response, the Trust and the Independent Trustees produced a limited number of documents, with certain documents involving legal advice provided to the Independent Trustees redacted or withheld in reliance on the attorney-client privilege. Thereafter, the plaintiffs moved to compel production of the redacted and withheld 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, which includes the right to refrain from producing a document in response to a subpoena, "where the document contains a confidential communication between a client and her attorney in which the client seeks legal advice." The purpose of the privilege is to encourage full and frank communications between attorneys and their clients. The fiduciary exception to the attorney-client privilege, which derives from trust law, prohibits trustees who obtain legal advice in connection with their administration of a trust from asserting the privilege with respect to the trust's beneficiaries. The exception is based on the notion that the benefit of legal advice provided to a trustee in connection with the administration of a trust runs to the trust's beneficiaries, to whom the trustee owes a fiduciary duty, and that, accordingly, communications relating to the provision of such legal advice should not be withheld from the beneficiaries.

The Court stated that, to establish the applicability of the fiduciary exception, otherwise known as the "*Garner* doctrine" after the seminal 1970 case *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970), "the party seeking discovery must establish both a fiduciary relation and good cause for overcoming the privilege." Citing *Garner*, the Court identified several factors that may establish good cause. These factors include: whether the claim is colorable; the apparent need or desirability for the party seeking production to have the information and the ability to obtain the information from other sources; whether the communication relates to past, present or prospective actions; whether the communication relates to legal advice relating to the litigation in connection with which production is being sought; the extent to which the communication is identified versus the extent to which the party seeking production is "blindly fishing"; and the risk of revealing trade secrets or other confidential information.

The Court conceded that several factors weighed in the plaintiffs' favor, including that the plaintiffs were not seeking communications related to the defense of, or discovery in, the present 36(b) litigation, there was no risk of disclosing trade secrets and, pursuant to a confidentiality order in place, the documents would not have been disclosed publicly. However, the Court determined that the plaintiffs failed to demonstrate the necessity of the information and its unavailability from other sources. In this connection, the Court noted its agreement with the Southern District of New York which, in previous cases, held that the necessity of the information and its unavailability from other sources is the "most important factor" in undertaking the *Garner* analysis and determining whether the attorney-client privilege should be pierced. Consequently, the Court denied the plaintiffs' motion to compel after determining that the plaintiffs had not met their burden to demonstrate good cause to overcome the attorney-client privilege based on the fiduciary exception.

In denying the plaintiffs' motion to compel, the Court distinguished the November 2016 order issued by the U.S. District Court for the Eastern District of Washington in *Kenny v. Pacific Investment Management Company LLC*, a Section 36(b) case in which, under similar facts, the court granted the plaintiff's motion to compel production of documents subject to the attorney-client privilege by applying the fiduciary exception. The Court found *Kenny* unpersuasive, noting that the U.S. Court of Appeals for the Ninth Circuit, which hears appeals from the U.S. District Court for the Eastern District of Washington, had not adopted the good cause standard from *Garner*, and that accordingly the *Kenny* court did not, and was not required to, apply that standard in determining the applicability of the fiduciary exception.

The Order was issued by the U.S. District Court for the Northern District of Illinois under the caption *Chill v. Calamos Advisors LLC, et al.*, Case No. 17-C-1658. The Order relates to Section 36(b) litigation currently pending in the U.S. District Court for the Southern District of New York under the caption *Chill v. Calamos Advisors LLC, et al.*, Case No. 15-C-1014 (S.D.N.Y. filed Feb. 11, 2015).

BlackRock Settles Charges of Operating ETF Without Required SEC Exemptive Relief

On April 25, 2017, the Securities and Exchange Commission (SEC) announced the settlement of administrative proceedings against BlackRock Fund Advisors (BlackRock) for causing iShares MSCI Russia Capped ETF (the Russia ETF), an exchange-traded fund (ETF) it advised, to operate in violation of Sections 22(d) and (e) of the 1940 Act and Rule 22c-1 thereunder.

Section 22(d) of the 1940 Act, among other things, prohibits a dealer from selling a redeemable security that is being offered currently to the public by or through an underwriter, except at a current public offering price described in the prospectus. Rule 22c-1 generally requires that a dealer selling, redeeming, or repurchasing a redeemable security only do so at a price based on the security's net asset value (NAV). As the SEC's order explains, because secondary market trading in shares of ETFs takes place at current market prices, and not at the current offering price described in the prospectus or based on the security's NAV, ETFs have obtained exemptions from Section 22(d) of the 1940 Act and Rule 22c-1 in order to operate lawfully. Section 22(e) of the 1940 Act also prohibits a registered open-end fund from suspending the right of redemption, or postponing the date of payment or satisfaction upon redemption for more than seven days after the tender of such security for redemption. As also explained in the SEC's order, ETFs that invest in foreign securities and effect redemptions in kind are sometimes unable to meet this requirement because the ETFs track foreign indexes with local market delivery cycles that require a delivery process in excess of seven days. Thus, ETFs and their sponsors also seek exemptive relief from Section 22(e) in order to operate without violating the 1940 Act.

The SEC order states that BlackRock believed that the Russia ETF, the sole series of iShares MSCI Russia Capped ETF, Inc. (the iShares Russia Registrant), was already covered by previously issued exemptive relief which had been granted to iShares Inc. and iShares Trust. Each of iShares Inc. and iShares Trust, the order explains, is an open-end management investment company consisting of numerous ETFs, each of which is organized as a series of iShares Inc. or iShares Trust, respectively. The order notes that in January 2007, the SEC granted exemptive relief to iShares Inc. and iShares Trust allowing them "to offer additional series, based on securities indices (the 'Future Funds'), without the need for additional exemptive relief from the Commission" (the iShares Future Fund Relief). The SEC order states that because the iShares Future Fund Relief only covered iShares Inc. and iShares Trust and their series, the separately organized iShares Russia Registrant and its series, the Russia ETF, were not covered by the iShares Future Fund Relief. Consequently, the SEC alleged that from December 2010, when the Russia ETF began selling its shares, until January 2015, when the Russia ETF was merged into a newly created series of iShares Inc., and in the absence of exemptive relief, BlackRock (1) caused shares of the Russia ETF to be purchased and sold at prices other than the NAV in the secondary market; (2) caused shares of the Russia ETF to be sold in the secondary market at negotiated prices, rather than a current public offering price described in the prospectus; and (3) caused the Russia ETF to violate Section 22(e) of the 1940 Act when it postponed the date of payment or satisfaction for more than seven days after its shares were tendered for redemption.

Pursuant to the terms of the order, BlackRock agreed to pay a civil money penalty of $1.5 million 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/2017/ic-32613.pdf.

Legislative Developments

Financial CHOICE Act of 2017 Would Impose Heightened Pleading Standards and Raise the Burden of Proof for Plaintiffs in Section 36(b) Excessive Fee Litigation

On April 19, 2017, the Chairman of the Financial Services Committee of the U.S. House of Representatives, Jeb Hensarling (R-TX), released an updated version of the Financial CHOICE Act (H.R. 10), the financial regulatory reform legislation that aims to repeal and replace various provisions of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. The latest version of the Financial CHOICE Act, dubbed "CHOICE 2.0," modifies, in several respects, the original bill (or "CHOICE 1.0") that was introduced in the last Congress and cleared the House Financial Services Committee, but did not advance to the full House of Representatives for a vote. The latest iteration of the bill has also been approved by the House Financial Services Committee, which recently passed CHOICE 2.0 in a 34-26 vote on May 4, 2017. Notably, CHOICE 2.0 includes amendments to Section 36(b) of the 1940 Act, which were not included in CHOICE 1.0, that would impose heightened pleading standards and raise the burden of proof for plaintiffs in excessive fee litigation. Section 36(b) imposes a fiduciary duty on investment advisers with respect to the compensation they receive for providing advisory services to funds and provides fund shareholders with an express private right of action to enforce this duty against advisers and their affiliates that receive compensation from funds. In such cases, the burden of proof rests on the plaintiffs to show, by a preponderance of the evidence, that the advisory fee is excessive, i.e., that the fee is "so disproportionate that it does not bear a reasonable relationship to the service the defendant rendered and could not have been negotiated at arm's-length."

CHOICE 2.0 would require that a complaint brought under Section 36(b) "state with particularity all facts establishing a breach of fiduciary duty, and, if an allegation of any such facts is based on information and belief, the complaint shall state with particularity all facts on which that belief is formed." In addition to the heightened pleading standards proposed under CHOICE 2.0, the bill would raise the burden of proof for plaintiffs from a "preponderance of the evidence" standard to a "clear and convincing evidence" standard. That is, under CHOICE 2.0, a fund shareholder would "have the burden of proving a breach of fiduciary duty by clear and convincing evidence."

The current draft of the bill is available at: https://www.congress.gov/115/bills/hr10/BILLS-115hr10ih.pdf.

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