VedderPrice

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Investment Services Regulatory Update

Market and Product Developments

Securities Industry Implements T+2 Settlement Cycle

On September 5, 2017, the securities industry transitioned to a shorter settlement cycle for most broker-dealer securities transactions, pursuant to amendments to Rule 15c6-1(a) under the Securities Exchange Act of 1934 adopted by the SEC in March 2017. As noted in a comment letter from the Investment Company Institute, the move from three business days after the trade date (i.e., T+3) to two business days after the trade date (i.e., T+2) for the standard settlement cycle reduces the timing mismatch and funding gap between settlement of a mutual fund's portfolio security trades and the settlement of transactions in the shares of the mutual fund itself (which generally settle on a T+1 basis), improving cash management for funds to meet redemptions.

In the SEC's adopting release for the rule amendments, the SEC acknowledged that a move to an even shorter T+1 settlement cycle "could have similar qualitative benefits of market, credit, and liquidity risk reduction for market participants as a move to a T+2 standard settlement cycle." Accordingly, the adopting release directs the staff of the SEC to submit a report to the SEC no later than September 5, 2020 that will include an examination of:

(1) the impact of the establishment of a T+2 standard settlement cycle on market participants, including investors;

(2) the potential impacts of moving to a shorter settlement cycle beyond T+2;

(3) the identification of technological and operational improvements that can be used to facilitate moving to a shorter settlement cycle; and

(4) cross-market impacts (including international developments) related to the shortening of the settlement cycle to T+2.

The SEC's adopting release is available at: https://www.sec.gov/rules/final/2017/34-80295.pdf.

Public Statements, Press Releases and Testimony

SEC Names Dalia Blass as Director of the Division of Investment Management

On August 31, 2017, the SEC announced that Dalia Blass has been named Director of the agency's Division of Investment Management, which is responsible for the oversight and regulation of registered investment companies, variable insurance products and registered investment advisers. Ms. Blass is returning to the SEC from private practice after previously having served in various capacities in the Division of Investment Management, most recently as Assistant Chief Counsel. Ms. Blass succeeds David Grim who had spent 22 years at the SEC, including two and a half years as Director of the Division of Investment Management.

The SEC's press release announcing the appointment of Ms. Blass is available at: [https://www.sec.gov/news/press-release/2017-153.](https://www.sec.gov/news/press-release/2017-153)

Litigation and Enforcement Actions

Ninth Circuit Affirms Dismissal of Breach of Contract and Fiduciary Duty Claims Against PIMCO but Rules Lower Court Should Have Dismissed Claims for Lack of Jurisdiction

On August 24, 2017, the U.S. Court of Appeals for the Ninth Circuit affirmed in part and vacated in part a decision by the U.S. District Court for the Central District of California dismissing various state law claims against Pacific Investment Management Company, LLC (PIMCO) as barred by the Securities Litigation Uniform Standards Act (SLUSA). SLUSA prohibits certain private class action lawsuits based on state law claims in cases in which the plaintiff alleges a material misrepresentation or omission connected to the purchase or sale of federally regulated securities. In a separately filed memorandum, the Ninth Circuit affirmed the District Court's holding that the class action claims in the case were barred by SLUSA. In its opinion, the Ninth Circuit sided with the U.S. Court of Appeals for the Third Circuit in holding that dismissals pursuant to SLUSA's class action bar must be for lack of subject-matter jurisdiction, and therefore without prejudice, rather than on the merits.

Background and Prior Proceedings

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 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 *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 barred by 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 District Court granted the defendants' motion to dismiss all of the plaintiff's claims, agreeing with the defendants that SLUSA barred the claims, and dismissed them with prejudice.

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 bars 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."

The District Court also concluded that a SLUSA provision commonly referred to as the "Delaware carve-out" did not apply to the plaintiff's claims. Under that provision, covered class actions based on state law are exempt from SLUSA's class action bar, so long as (1) they are based on the law of the state in which the securities issuer is organized, and (2) involve either transactions exclusively between the issuer and its existing shareholders, or a communication the issuer makes to its shareholders "concerning decisions of those equity holders with respect to voting their securities, acting in response 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, and therefore the action "concerns decisions of those equity holders with respect to voting their securities." The defendants disputed that the change in investment restriction required a shareholder vote but argued that, in any event, no vote was held, so the action cannot credibly be said to "concern decisions of those equity holders with respect to voting their securities." The District Court agreed with the defendants and explained that the second prong is designed to exempt cases where entities provide false or misleading information in advance of a vote in an attempt to induce security holders to vote in a certain way.

In dismissing the plaintiff's claims, the District Court frequently cited the 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 bar several similar state law claims based on alleged 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.

Treatment of Claims on Appeal

On appeal, the plaintiff challenged the District Court's (1) conclusion that his claims are barred by SLUSA, and (2) decision to dismiss his claims with prejudice as a result.

As to the application of SLUSA, the plaintiff asserted that his complaint was "carefully drafted" to avoid "alleging" a material falsehood or omission and that his contract and fiduciary duty claims did not depend on any showing of false statements. Since SLUSA applies only to private plaintiffs "alleging" an untrue statement or omission of material fact, the plaintiff argued that SLUSA should not apply.

The Ninth Circuit, however, rejected the plaintiff's "narrow, technical approach" to the statute, stating that "courts broadly recognize that SLUSA's applicability does not depend on whether the plaintiff *expressly* makes the predicate allegations" (emphasis in original). In this regard, the Ninth Circuit noted that "artful pleading" cannot circumvent the "presumption that Congress envisioned a broad construction of SLUSA in order to effectuate its stated purpose of preventing state-law claims from making an end-run around the safeguards imposed by the Private Securities Litigation Reform Act" (internal quotation marks omitted).

According to the Ninth Circuit, SLUSA's "alleging standard is satisfied when deceptive statements or conduct form the gravamen or essence of the *claim*" (emphasis added in original; internal quotation marks omitted). Applying the foregoing to the plaintiff's claims, the Ninth Circuit stated that "[t]he fact that PIMCO Funds promised to follow one course of action, at the same time it did the exact opposite, raises the likelihood of falsity that SLUSA requires." Indeed, the Ninth Circuit stated that the "strong implication of falsity"—i.e., that the PIMCO Funds made an untrue statement of material fact relevant to the core of the plaintiff's claim—distinguishes the case from other decisions in the Ninth Circuit in which there were no allegations suggesting that the statements at issue were false when made.

As to the District Court's decision to dismiss the plaintiff's claims with prejudice, the Ninth Circuit agreed with the plaintiff that the dismissal should have been without prejudice because SLUSA enacts a jurisdictional bar rather than a defense on the merits. As explained in the opinion, dismissals for lack of subject-matter jurisdiction must be without prejudice, because a lack of jurisdiction deprives the dismissing court of any power to adjudicate the merits of the case. "Because the district judge had no jurisdiction to reach the merits of [the plaintiff's] claims, he had no power to dismiss them with prejudice."

The opinion closes with a "brief word on what comes next," and explains that SLUSA's jurisdictional bar, applicable in state court as well as in federal court, applies only when an individual plaintiff pleads state law claims as a class action. Thus, the Ninth Circuit noted, although the plaintiff may not replead state law claims on a class basis, he is free to replead such claims on an individual basis, or to plead new federal securities claims either as an individual or as a class representative, provided that, in either case there are no other applicable jurisdictional barriers.

The case is *William T. Hampton v. Pacific Investment Management LLC*, et al., No. 15-56841 (9th Cir. 2017).

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