ROPES & GRAY

UPDATE

Asset Management

December 8, 2015

# Ropes & Gray's Investment Management Update: October – November 2015

The following summarizes recent legal developments of note affecting the mutual fund/investment management industry:

## District Court Rules on Motion to Dismiss on Remand of *Northstar Financial Advisors Inc. v. Schwab Investments*

In our October 7, 2015 Investment Management Update, we reported that the U.S. Supreme Court had announced on October 5, 2015 that it would not grant certiorari to review the March 2015 decision of the Ninth Circuit in *Northstar Financial Advisors Inc. v. Schwab Investments* ("Northstar"). On the same day that the U.S. Supreme Court denied the Northstar defendants' petition for certiorari, the U.S. District Court for the Northern District of California issued its opinion resulting from the Ninth Circuit's remand in Northstar. As a reminder, in Northstar, the Ninth Circuit ruled that three novel state law claims were validly pled by a plaintiff seeking to represent a class of mutual fund shareholders. The state law claims were based on theories of breach of contract against the fund, breach of fiduciary duty against the trustees and adviser, and breach of the investment advisory agreement against the adviser. Most notably, the Ninth Circuit permitted all three state law claims to be brought directly, rather than derivatively.

On remand, the district court granted the defendants' motion to dismiss with respect to the third-party beneficiary claims for breach of the advisory agreement against the adviser and the claims for breach of contract against the trust based on statements made in the fund's proxy statement and prospectus. In each case, the court found the substance of the claim was essentially based on a misrepresentation or omission – namely, that the defendants "stated that they would do one thing, and ended up doing another." As a result, the district court concluded that these claims fell within the scope of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preclusion, which bars the filing of what are essentially federal securities laws misrepresentation claims as state law causes of action. The court also dismissed the breach of fiduciary duty claims against the trust, finding that the fiduciary duties owed to the shareholders are owed by those responsible for managing the trust (*i.e.*, the trustees and the adviser) rather than the trust itself.

However, the district court found that the trustees and the adviser could not raise a SLUSA defense as to the breach of fiduciary duty claims because they had failed to assert the defense in their motion to dismiss the plaintiff's earlier third amended complaint. Therefore, the breach of fiduciary duty claims against the trustees and the adviser survived the defendants' motion to dismiss.

We expect that the district court's opinion to be appealed to the Ninth Circuit sometime in 2016.

In our view, while the district court's opinion is favorable to funds and their advisers and board members, it does not diminish the potential risks posed by the Ninth Circuit's Northstar decision. SLUSA preclusion is very fact specific, turning on the allegations of a given complaint. Although the district court held that certain of the plaintiff's allegations sounded in misrepresentation, plaintiffs in other cases may assert alternative claims that a court concludes do not sound in misrepresentation (and, therefore, were not precluded by SLUSA).

## District Court Dismisses Claims in a Northstar Copycat Suit – *Hampton v. PIMCO, LLC*

On November 2, 2015, in *Hampton v. PIMCO, LLC*, the U.S. District Court for the Central District of California granted the defendants' motion to dismiss a putative shareholder class action that had been filed against a fund and its adviser and trustees. When filed in January, the plaintiff's complaint alleged various misrepresentations by the defendants in violation of Rule 10b-5 under the Exchange Act. The plaintiff's amended complaint, filed in July 2015, dropped the federal securities law claims and, instead, made direct claims against the defendants under various state law theories, includin1 g breach of contract and breach of trust. The amended complaint appeared to have been reworked to try to take advantage of the Ninth Circuit's holdings in Northstar.

In its November 2 decision, the district court held that each of the plaintiff's claims rested on allegations of misrepresentations by the adviser, the fund, or the fund's trustees. Therefore, the court found that the plaintiff's claims were precluded by SLUSA and, therefore, dismissed each of the claims.

The plaintiff filed a notice of appeal of the district court decision with the Ninth Circuit on November 30.

### New York Life Excessive Fee Case Survives Motion to Dismiss

On October 28, 2015, the U.S. District Court for the District of New Jersey issued an opinion denying the adviser's, New York Life Investment Management LLC's ("NYLIM"), motion to dismiss a suit in which plaintiffs allege that NYLIM breached its fiduciary duty under Section 36(b) of the 1940 Act by charging excessive fees to four mutual funds. The plaintiffs alleged that the fees were excessive because the subadvisers hired by NYLIM for each of the funds performed "substantially all of the investment advisory services required by each [f]und." The plaintiffs asserted that, in light of the scope of the services provided by the subadvisers, the large "mark-up" retained by NYLIM out of the management fees paid by the four funds (approximately 47 percent of the aggregated fees) was disproportionate to the services NYLIM actually rendered to the funds. The plaintiffs also alleged that NYLIM had not appropriately shared economies of scale with investors because of the way the funds' breakpoints are structured.

The district court analyzed the plaintiffs' claims and concluded that the plaintiffs had "adequately alleged that NYLIM charged a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." In particular, analyzing the plaintiffs' claims under the *Jones/Gartenberg* factors, the court found that the plaintiffs had pleaded sufficient facts with respect to three of the six *Jones/Gartenberg* factors and, therefore, the plaintiffs' complaint was sufficient to withstand NYLIM's motion to dismiss.

The NYLIM case is one of many Section 36(b) lawsuits filed within the last several years that focus on the fee split between subadvisers and a principal adviser. Many of these lawsuits have survived motions to dismiss, and the first of these cases is scheduled for trial in January 2016.

## Regulatory Priorities Corner

The following brief updates exemplify trends and areas of current focus of relevant regulatory authorities:

### SEC OCIE Issues Risk Alert on Outsourced CCOs

On November 9, 2015, the SEC's Office of Compliance Inspections and Examinations ("OCIE") issued a Risk Alert (the "Alert") to raise awareness of potential compliance issues arising from the growing trend in the investment management industry of outsourcing compliance activities, including outsourcing the role of adviser or fund chief compliance officer ("CCO"). The Alert states that its purpose is to share OCIE staff's observations from nearly 20 examinations of advisers and funds ("registrants") that outsource their CCOs to unaffiliated third parties ("outsourced CCOs").

OCIE staff's general observations regarding outsourced CCOs included:

- Communications. Outsourced CCOs who have frequent and personal interaction with adviser and fund employees (instead of impersonal interaction, such as email and pre-defined checklists) appear to have a better understanding of the registrants' businesses, operations, and risks. These registrants tend to have fewer inconsistencies between their compliance policies and procedures and their actual business practices, and their outsourced CCOs were typically able to effect compliance changes that are deemed necessary.

- Resources. More significant compliance issues were identified at registrants with an outsourced CCO who also served as outsourced CCO for multiple registrants and who did not appear to have adequate resources, particularly in view of the varied nature of registrants served by the outsourced CCO.
- Empowerment. Outsourced CCOs who were able to obtain registrants' records independently – without relying on registrants to select the records – produced annual reviews that better reflected the registrants' actual practices.

OCIE staff's specific observations regarding the strength and effectiveness of the registrants' compliance programs included:

- Outsourced CCOs who used standardized or generic checklists to gather information regarding registrants may not fully capture the business models, practices and compliance risks applicable to the registrants. Similarly, compliance manuals that had been created based upon templates provided by outsourced CCOs may not have been tailored to registrants' specific businesses and practices. Therefore, the resulting compliance manuals contained policies and procedures that were inappropriate or inapplicable to the registrants' businesses.
- Registrants that relied on outsourced CCOs were less likely to have written policies, procedures or disclosures to address all of the conflicts of interest identified by the OCIE (e.g., compensation practices, portfolio valuation, brokerage and execution, and personal securities transactions by access persons).
- Outsourced CCOs were typically responsible for conducting and documenting registrants' annual compliance program reviews, including testing for compliance with existing policies and procedures. However, there was a general lack of documentation evidencing such testing.
- Some outsourced CCOs visited registrants' offices infrequently and conducted reviews of compliance documents off-site. Consequently, the outsourced CCOs' visibility within registrants' organizations appeared to be limited, resulting in outsourced CCOs with limited authority to improve compliance policies and procedures.

The Alert notes that registrants, particularly those that use outsourced CCOs, may want to consider the contents of the Alert to assess whether their particular business and compliance risks were identified so that related policies and procedures were appropriately tailored to these risks. The Alert also recommends that registrants consider whether their CCO is sufficiently empowered within the registrant organization to fulfill the responsibilities of a CCO.

## Adviser Enters into Settlement with SEC for Advertising False Performance Claims

On November 16, 2015, Virtus Investment Advisers, Inc. ("Virtus") agreed to settle allegations resulting from an SEC investigation into alleged misstatements by Virtus to certain of its mutual fund clients and to those funds' shareholders concerning the performance record of the funds' subadviser, F-Squared Investments, Inc. ("F-Squared").

F-Squared used a proprietary investment strategy called AlphaSector. Between September 2009 and May 2015, Virtus advised six mutual funds that relied on AlphaSector and employed F-Squared as subadviser to the funds. The SEC alleged that from May 2009 to September 2013, in certain client presentations, marketing materials, filings with the SEC, and other communications, Virtus had stated falsely that (i) the AlphaSector strategy had a history that dated back to April 2001 and had been in use since then; and (ii) the strategy had significantly outperformed the S&P 500 Index from 2001 to September 2008.

The SEC found that F-Squared had not employed the strategy from 2001 through September 2008 and had overstated the hypothetical performance of AlphaSector for the period. Thus, Virtus was alleged to have advertised the AlphaSector strategy by using hypothetical and back-tested historical performance that was substantially inflated.

The SEC also alleged that Virtus had failed to adopt and employ adequate policies and procedures regarding the accuracy of performance information from third parties in Virtus' marketing materials and other disclosures.

As part of the SEC settlement, Virtus agreed to disgorge $13.4 million and pay prejudgment interest of $1.1 million.

## SEC Sanctions Adviser for False Claims of GIPS Compliance in its Advertisements

On October 30, 2015, the SEC upheld an administrative law judge's decision regarding an adviser, ZPR Investment Management, Inc. ("ZPR"), and its former president and owner ("Zavanelli"). The SEC found that ZPR had violated various anti-fraud provisions of the Advisers Act, as well as the "advertising rule," Rule 206(4)-1, under the Advisers Act, by misrepresenting ZPR composite's compliance with the Global Investment Performance Standards ("GIPS") in magazine advertisements and investment report newsletters. Zavanelli was found to have caused each of ZPR's violations based on these misrepresentations. The SEC imposed a $250,000 civil money penalty on ZPR and a $570,000 civil money penalty on Zavanelli. The SEC also permanently barred Zavanelli from association with any adviser, broker or dealer.

## SEC Focused on Variable Annuity Fee Table Disclosure and Buyback Offer Disclosure

On November 2, 2015, at an industry conference on insurance company investment products, David Grim, Director of the SEC's Division of Investment Management, spoke on the regulatory and compliance issues affecting investment products issued by insurance companies. In particular, Director Grim identified two disclosure areas that have garnered increased focus by the SEC. First, he stated that the variable annuity fee table has become quite complicated for many products, particularly those that include various guaranteed benefit riders, and noted that the staff is looking for a clear and comprehensive fee table when reviewing variable annuity filings. Separately, Director Grim discussed a trend that the staff has observed among several variable product issuers. He stated that the staff "continues to see buyout offers [to contract holders] relating to variable insurance contracts with generous guaranteed income benefits and death benefits that, over time, have proven costly for insurance companies and their hedging programs in light of the ongoing low interest rate environment." He noted that certain offers to contract owners limit an insurer's exposure under existing guaranteed benefits, and may not be beneficial for all, or even most, contract owners. Accordingly, Director Grim indicated that the staff will continue to review carefully the disclosure relating to such offers, and he encouraged the industry to monitor sales practices associated with these offers carefully.

## DOL Issues Guidance on Economically Targeted Investments

In October, the Department of Labor ("DOL") published Interpretive Bulletin ("IB") 2015-01 providing guidance to pension plan fiduciaries on ERISA standards as applied to "economically targeted investments" ("ETIs") – defined as "investments that are selected for the economic benefits they create in addition to the investment return." This new guidance withdraws IB 08-01 and reinstates the language of IB 94-01 stating that such considerations may be used as "tie-breakers" to decide between economically equivalent investments. IB 08-01 was withdrawn, in part, because the DOL believed the prior guidance "unduly discouraged" fiduciaries from investing in ETIs even where economically equivalent to competing investments or from pursuing strategies that considered environmental, social and governance ("ESG") factors. This latest release confirms the DOL's view that under Section 403 and 404 of ERISA, fiduciaries may invest in ETIs based on their collateral benefits so long as the investment is appropriate for the plan and economically equivalent to competing investments. In the preamble to IB 2015-01, the DOL states that ESG factors may have a direct relationship to the economic value of an investment. In these instances, the factors act as more than just "tie-breakers" and are proper components of economic analysis. The DOL noted, however, that consideration of these factors does not allow a plan fiduciary to sacrifice economic interests in pursuing collateral benefits.

## Regulators Provide Guidance on ESC Securities Held by a State

In IM Guidance Update No. 2015-04 (the "Guidance"), the Division of Investment Management provided guidance regarding states holding securities issued by Employees' Securities Companies ("ESCs"). Under Section 2(a)(13) of the 1940 Act, ESCs are employer-sponsored investment companies, the beneficial owners of which generally include only current and former employees and employer retainers ("Eligible Holders"). The Guidance notes that the SEC has exercised its exemptive authority by exempting ESCs from various restrictions that would otherwise apply under the 1940 Act.

On occasion, the Guidance states, a state may become the holder of an ESC's securities through operation of the state's escheatment laws. States are not Eligible Holders. This raises the question of what effect a transfer of ESC securities to a state by operation of the state's escheatment law has on the ESC's ability to rely on an existing exemptive order.

The Guidance states the Division of Investment Management would not object if an ESC continued to rely on its exemptive order under the 1940 Act if securities issued to Eligible Holders consistent with the ESC's relevant exemptive order are remitted to, and held by, a state, by operation of the state's escheatment law. However, this position is limited to the transfer of ESC securities to a state by operation of the state's escheatment law, and does not extend to any other transfers of ESC securities.

### SEC Announces Results of 2015 Enforcement Program

On October 22, 2015, the SEC announced its enforcement results for its fiscal year ended September 30, 2015. According to the announcement, the SEC filed 807 enforcement actions in fiscal 2015 covering a wide range of misconduct (compared to 755 such actions in the prior year), and obtained orders totaling approximately $4.2 billion in disgorgement and penalties (compared to $4.16 billion in the prior year).

## Other Developments

Since the last issue of our IM Update, we have also published the following separate Alerts of interest to the investment management industry:

U.S. Banking Regulators Finalize Minimum Margin Requirements for Uncleared Swaps
November 2, 2015
On October 22, 2015, U.S. federal banking regulators jointly adopted final rules establishing minimum margin and capital requirements for uncleared swaps and uncleared security-based swaps executed by registered swap dealers, major swap participants, security-based swap dealers and major security-based swap participants for which there is a prudential regulator ("swap entities").

While the margin rules do not apply directly to buy-side entities, they will have a material impact on buy-side entities that use uncleared derivatives. They will impose minimum margin requirements on derivatives transactions between buy-side entities and swap entities and may increase the amount of margin buy-side entities are required to provide. They will impose regulatory requirements on the timing of transferring margin, which will accelerate the current margin process for many buy-side entities. They will also effectively require changes to typical derivatives margin documentation, including the ISDA Credit Support Annex.

SEC Issues Staff Legal Bulletin Outlining the Scope of the "Directly Conflicts" Exclusion under Rule 14a-8 and Providing Guidance on the Staff's Interpretation of the Ordinary Business Exclusion
October 26, 2015
On October 22, 2015, the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14H, in which it provides guidance on two key issues surrounding the exclusion of shareholder proposals under Rule 14a-8: (i) the scope and application of Rule 14a-8(i)(9), regarding shareholder proposals that conflict with a company's own proposal and (ii) the scope and application of Rule 14a-8(i)(7), regarding shareholder proposals that deal with matters relating to a company's ordinary business operations. In each case these rules and interpretations also apply to registered investment companies.

If you would like to learn more about the developments discussed in this Update, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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