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REGULATORY ADMINISTRATION DIGEST

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The following is a summary of select developments in investment management regulation during the fourth quarter of 2015.

SEC PROPOSES NEW LIMITATIONS ON USE OF DERIVATIVES

In December 2015, the Securities and Exchange Commission ("SEC") published a proposed rule (the "Proposed Rule") that would enhance the regulation of the use of derivatives by registered investment companies, including mutual funds, exchange-traded funds (ETFs) and closed-end funds, as well as business development companies. Among other things, the Proposed Rule would limit funds' use of derivatives and require them to put risk management measures in place. In a press release announcing the Proposed Rule's adoption, SEC Chair Mary Jo White stated that the Proposed Rule "is designed to modernize the regulation of funds' use of derivatives and safeguard both investors and [the] financial system."

First, the Proposed Rule would require that funds comply with one of two alternative portfolio limitations – exposure-based and risk-based – in connection with its derivatives transactions. Under the exposure-based limitation, funds would be required to limit aggregate derivatives exposure to 150% of fund net assets. Under the risk-based limitation, funds would be permitted to obtain exposure up to 300% of fund net assets, provided that the fund satisfies a risk-based test (based on value-at-risk) designed to determine whether the fund's derivatives transactions, in aggregate, result in a fund portfolio that is subject to less market risk than if the fund did not use derivatives.

The Proposed Rule also would require that, in connection with derivative transactions, funds segregate assets (generally cash and cash equivalents) equal to the sum of: (i) the amount that the fund would pay if the fund exited the derivatives transaction at the time of the determination; plus (ii) an amount that represents a reasonable estimate of the potential obligations of the fund under stressed conditions. In addition, funds that enter into financial commitment transactions would be required to segregate assets with a value equal to the full amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under those transactions.

Furthermore, the Proposed Rule would impose additional requirements on funds that engage in more than limited derivatives transactions or use complex derivatives. Those funds would be required to establish a formal derivatives risk management program administered by a designated derivatives risk manager, both of which would have to be approved and reviewed by the fund's board of directors. The risk management program requirements would be in addition to certain requirements related to derivatives risk management that would apply to every fund that enters into derivatives transactions in reliance on the Proposed Rule.

Comments on the Proposed Rule will be due on March 28, 2016.

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OCIE Publishes Results of Examinations Focused on Outsourced CCOs

In November 2015, the Office of Compliance Inspections and Examinations ("OCIE") of the SEC released a National Exam Program Risk Alert on the results of the OCIE's examination of nearly 20 investment advisers and funds that outsource their chief compliance officer function to unaffiliated third parties ("Outsourced CCOs"). The Risk Alert includes OCIE's observations from the examinations, which yielded mixed results. In certain instances, the OCIE found that the Outsourced CCOs were generally effective in administering the Registrant compliance program, as well as fulfilling his/her other responsibilities as chief compliance officer. In other instances, the OCIE observed compliance weaknesses associated with the outsourcing of the chief compliance officer role.

In general, the OCIE observed that characteristics of effective Outsourced CCOs included:

- regular, often in-person, communication between the CCOs and the Registrants;
- strong relationships established between the CCOs and the Registrants;
- sufficient Registrant support of the CCOs;
- sufficient CCO access to Registrants' documents and information; and
- CCO knowledge regarding regulatory requirements and the Registrants' business.

The Staff also observed compliance weaknesses in the compliance programs of Registrants with Outsourced CCOs. Specific concerns about the Outsourced CCOs' implementation and evaluation of Registrant compliance programs included:

- lack of meaningful risk assessment (e.g., inability to identify applicable Registrant business and compliance risks);
- failure to adopt, implement and/or adhere to policies and procedures reasonably designed to prevent the violation of applicable regulations or that were relevant in light of the Registrant's business; and
- inadequate documentation evidencing the testing in the area of risk assessment in connection with the annual review of Registrant compliance programs.

In light of the examination results, the OCIE suggests that Registrants using Outsourced CCOs consider the issues identified in the Risk Alert to evaluate whether their: (i) business and compliance risks have been appropriately identified; (ii) policies and procedures are appropriately tailored in light of their business and associated risks; and (iii) CCO is sufficiently empowered within the organization to effectively perform his/her responsibilities.

JUNK BOND FUND COLLAPSE LEADS TO SEC LIQUIDITY SWEEP

On December 9, 2015, Third Avenue Focused Credit Fund (the "Focused Credit Fund") was forced to halt redemptions and place its assets in a liquidating trust, as the fund's net asset value tumbled and redemption requests continued to pour in. According to analysts, over 20 percent of the Focused Credit Fund's holdings were comprised of illiquid assets, leading the fund and its board to conclude that despite a $200 million cash base, they could no longer keep up with increasing redemption requests and blocking redemptions would be the only way to prevent a run on the assets of the fund. This followed a year of massive outflows that reduced the Focused Credit Fund's $2.9 billion asset base at the end of November 2014 to $788.5 million at the time of liquidation. Although the fund took the unusual step of freezing redemptions without first obtaining approval from the SEC, the SEC granted a subsequent request for exemptive relief, citing the need for "immediate action to protect the Fund's shareholders."

Seemingly in response to this event, the SEC initiated a sweep exam of high-yield funds with similar holdings. Fund managers were asked to produce all manner of documentation related to flows, valuation, and liquidity management, including both fund management and board governance materials, as the SEC attempted to gauge the ability of other high-yield funds to grant redemptions at a high volume should the need arise.

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This has been an area of focus for the SEC in recent months. In September 2015, the SEC proposed new rules for liquidity management, and liquidity controls were a topic of emphasis in the SEC's recently released examination priorities for 2016.

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VIRTUS SETTLES FALSE ADVERTISEMENT CLAIM FOR $16.5 MILLION

On November 16, 2015, the SEC announced that Virtus Investment Advisers ("Virtus") agreed to pay $16.5 million to settle charges of misleading mutual fund investors with advertisements that contained false historical performance data. The misstatements concerned the performance of Virtus' subadviser, F-Squared Investments, Inc. ("F-Squared").

At issue was Virtus's advertisement of F-Squared's AlphaSector Exchange-Traded Fund strategy. In a separate proceeding in December 2014, F-Squared admitted to representing backtested and hypothetical performance data as historical, as well as erroneously inflating the hypothetical data by approximately 350%. An SEC investigation found that Virtus utilized this inaccurate performance data as received from F-Squared for marketing purposes, and recommended changes in management and strategy to F-Squared and AlphaSector based on this data, all without verifying its accuracy. Specifically, the SEC found that despite having reservations regarding the data from the outset, Virtus failed to "adequately investigate" their concerns regarding the representations being made.

The SEC's actions in this case appear to put the impetus on fund complexes to thoroughly vet the performance data that they receive from subadvisers, especially when warning signs exist regarding the validity of that data. This has the potential to create something of a conundrum for funds, as backup data can just as easily be falsified by the subadviser, and independent verification of proprietary investment strategies could prove difficult to obtain. However, it seems clear that merely taking a subadviser's performance claims at face value is not sufficient. As Andrew J. Ceresney, Director of the SEC Enforcement Division, stated: "Virtus accepted F-Squared's historical performance misrepresentations at face value and ignored red flags that called these statements into question. If an investment adviser chooses to advertise, it is responsible for the content and accuracy of its ads."

DISTRICT COURT RULES ON MOTION TO DISMISS IN *NORTHSTAR FINANCIAL ADVISORS INC. V. SCHWAB INVESTMENTS*

On October 5, 2015, the United States District Court for the Northern District of California issued its opinion in *Northstar Financial Advisors Inc. v. Schwab Investments*. This follows the United States Court of Appeals for the Ninth Circuit's

holding earlier last year that the plaintiffs' state law breach of contract, breach of fiduciary duty and breach of third party beneficiary contract claims were sufficient to survive defendants' motion to dismiss. On remand, the district court granted the defendants' motion to dismiss in part and denied in part.

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The district court granted the defendants' motion to dismiss with respect to (i) the third-party beneficiary claims for breach of the advisory agreement against the adviser and (ii) the claims for breach of contract against the trust, finding that these claims fell within the scope of the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") preclusion. SLUSA provides: "No covered class action based upon the statutory or common law of any State or subdivision thereof may be maintained in any State or Federal court by any private party alleging a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." In the case of *Northstar*, the district court found that the substance of the plaintiffs' claims consisted of allegations of misrepresentations or omissions in statements made in the fund's prospectus and proxy statement. Additionally, the breach of fiduciary duty claims against the trust were dismissed, as the court found that the fiduciary duties owed to the shareholders are owed by the trustees and the adviser as opposed to the trust itself.

However, the district court denied the defendants' motion to dismiss the breach of fiduciary duty claims against the trustees and adviser, noting that the defendants did not assert the SLUSA defense with respect to that claim in their previous motion to dismiss the plaintiff's third amended complaint. As SLUSA preclusion is very fact specific, the door remains open for potential future litigation on the state law grounds that the Ninth Circuit validated. An appeal of the district court's decision can reasonably be expected sometime this year.

FUND BOARDS EXCEEDING REGULATORY OBLIGATIONS IN ADOPTING SHAREHOLDER-FRIENDLY PRACTICES

On October 27, 2015, the Investment Company Institute ("ICI") and Independent Directors Council ("IDC") released their biennial study, *Overview of Fund Governance Practices, 1994 – 2014*. The study, which utilized board governance data gathered from fund complexes over the past 20 years, found that fund boards have steadily improved in the implementation of practices that promote better oversight on behalf of shareholders. Additionally, the study found that fund boards have regularly gone above and beyond the dictates of regulatory mandate, and that they have often taken these measures in advance of, or in the absence of, regulatory action.

Key findings of the report include:

- Nearly two-thirds of fund complexes have an independent board chair, and 89 percent of complexes have an independent director in board leadership as of year-end 2014, up from 22 percent in 1996.
- Independent directors made up at least three-quarters of boards in 83 percent of fund complexes in 2014, up from 46 percent in 1996.
- More than nine in ten fund complexes report that separate legal counsel serves their independent directors.
- Although not required to do so, 97 percent of fund complexes report having at least one financial expert on the audit committee.

"Based on our survey, the clear trend in fund governance is for funds to implement practices that surpass any legal requirements, which serves fund shareholders well," said Amy Lancellotta, IDC's Managing Director. Robert W. Uek, IDC Chairman, added, "Clearly, fund boards have increased the depth of their oversight as the industry has grown and the issues affecting fund boards have continued to become more complex. This report indicates that shareholders should be confident that directors are keeping a close watch on their funds."

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For further information, contact: Owen Meacham, Esq. at otm1@ntrs.com or 312.557.3948 or visit northerntrust.com/fundservices.

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