Issue 24, July 2015

REGULATORY ADMINISTRATION DIGEST

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

TOPICS IN THIS ISSUE:

MUTUAL FUND TRUSTEES AND ADVISER SETTLE SEC CHARGES RELATED TO THE ADVISORY CONTRACT RENEWAL PROCESS

In an order instituting settled administrative and cease and desist proceedings, the Securities and Exchange Commission (the "SEC") alleged that the trustees and investment adviser of World Funds Trust and World Funds, Inc. (collectively, the "Funds"), both open-end registered investment companies, "failed to satisfy specific duties" imposed by the Investment Company Act of 1940 (the "1940 Act") in connection with the evaluation of the Funds' advisory contracts. The SEC found that the trustees and the adviser willfully violated Section 15(c) of the 1940 Act ("Section 15(c)") as a result of the trustees' approval of advisory contracts without having all the information they requested as reasonably necessary for their evaluation. In addition, the SEC found that the Funds' administrator caused the Funds to violate Section 30(e) of the Investment Company Act and Rule 30e-1, thereunder, by failing to provide the discussion of the Section 15(c) process in the Fund's shareholder report that is required by Form N-1A.

In a press release announcing the settlement, the Director of the SEC Enforcement Division, Andrew J. Ceresney, stated that "[a]s the first line of defense in protecting mutual fund shareholders, board members must be vigilant," and that the Fund's trustees had "failed to fully discharge their fund governance responsibilities on behalf of fund shareholders."

Without admitting or denying the SEC's findings, each Trustee agreed to pay a $3,250 civil penalty; the Adviser, the administrator and their principal agreed to jointly and severally pay a $50,000 civil penalty; and the adviser and trustees agreed to cease and desist from committing or causing any violations and any future violations of Section 15(c) of the 1940 Act.

NINTH CIRCUIT RECOGNIZES SHAREHOLDERS' PRIVATE RIGHT OF ACTION AGAINST MUTUAL FUND, ITS TRUSTEES AND ITS INVESTMENT ADVISER

TOPICS IN THIS ISSUE:

In *Northstar Financial Advisors Inc. v. Schwab*[*], the United States Court of Appeals for the Ninth Circuit refused to reconsider its prior ruling that shareholders of a registered investment company could pursue state law claims against: (i) the registered investment company for breach of contract; (ii) the registered investment company's trustees and investment adviser for breach of fiduciary duty; and (iii) the registered investment company's investment adviser for breach of the investment advisory agreement, as third-party beneficiaries to the agreement. The court's decision was the latest development in a case that began in 2008, when Northstar Financial Advisors, Inc. ("Northstar") filed a class action suit on behalf of shareholders of Schwab Total Bond Market Fund (the "Fund"), a series of Schwab Investments, a Massachusetts business trust ("Schwab"), against the Fund, the Fund's board of trustees, and Charles Schwab Investment Management, Inc., the Fund's investment adviser. Northstar alleged that the Fund significantly underperformed during the period in question deviated as of result of deviation from its fundamental investment objective of tracking the Lehman Brothers U.S. Aggregate Bond Index and from its fundamental investment policy of not investing more than 25% of its total assets in any one industry. The Ninth Circuit had previously reversed a district court decision dismissing Northrstar's claims for breach of contract and fiduciary duty and third-party beneficiary contract.

***Breach of Contract*.** The Ninth Circuit found that "the mailing of the proxy statement and the adoption of the two fundamental investment policies after the shareholders voted to approve them, and the annual representations by the Fund that it would follow these policies are sufficient to form a contract between the shareholders on the one hand and [Schwab] on the other." As such, the Ninth Circuit held that a valid contract existed between the Fund and its shareholders, and that deviation from its stated investment objectives provides shareholders valid grounds from which to sue.

Breach of Fiduciary Duty. The court also found that a fiduciary relationship existed between the trustees and the shareholders. In doing so, the Circuit Court overruled the District Court, and precedent, which took the position that the trustees of a

[*] *Northstar Financial Advisors, Inc. v. Schwab Invs.*, 779 F.3d 1036, 2015 (9th Cir. 2015), as amended by *Northstar Financial Advisors, Inc. v. Schwab Invs.*, 2015 U.S. App. LEXIS 7027 (9th Cir. 2015).

mutual fund organized as a Massachusetts business trust owe a fiduciary duty to the trust, and not the shareholders themselves.

Third-Party Beneficiary Claim for Breach of Contract. Lastly, the court held that the investment advisory contract between the adviser and the Fund was entered into for the benefit of the shareholders of the Fund, and as such, the shareholders had a valid third-party beneficiary claim against the adviser. Commentators have noted that the impact of the decision may be limited given the Ninth Circuit's significant reliance on Massachusetts state law. They also cite the existence of conflicting court decisions and the likelihood of possible petitions to the U.S. Supreme Court.

SEC SEEKS TO MODERNIZE AND ENHANCE INVESTMENT COMPANY REPORTING

The SEC has published new rule proposals designed to enhance data reporting for mutual funds and other registered investment companies, and to take advantage of technological advances in the reporting and accessibility of fund information. The proposals include:

New Form N-PORT. Funds would use Form N-PORT for reporting information currently reported on Forms N-Q and N-CSR. Reports on Form N-PORT would be filed monthly with the SEC, with every third month available to the public 60 days after the end of the fund's fiscal quarter. The reports on Form N-PORT would include a fund's complete portfolio holdings currently provided on Form N-Q in a structured data format as of the end of each first and third fiscal quarter, and on Form N-CSR as of the end of each second and fourth fiscal quarter.

New Form N-CEN. In lieu of Form N-SAR, Funds would report census information on Form N-CEN on an annual basis. Currently, funds are required to report census information to the SEC on Form N-SAR on a semi-annual basis. Reports on Form N-CEN would include many of the same data elements as Form N-SAR, with some changes that replace items that are outdated or of limited use with items that the SEC believes to be of greater relevance today and that eliminate items that are reported elsewhere. In addition, the reports on Form N-CEN would be filed in a structured XML format.

Amendments to Regulation S-X. Proposed amendments to Regulation S-X would require various changes to fund financial statements, including new standardized disclosures regarding fund derivative holdings; prominent placement of disclosures

regarding investments in derivatives; and a new disclosure in the notes to the financial statements relating to a fund's securities lending activities.

Optional Website Transmission of Shareholder Reports. Under proposed rule 30e-3, the SEC will permit (but not require) funds to satisfy certain annual report delivery requirements by making shareholder reports and certain other materials accessible on its website if the following conditions are met that relate to: (i) availability of the report and other materials, (ii) shareholder consent, (ii) notice to shareholders, and (iv) delivery of materials upon shareholder request.

If the proposals ultimately are adopted by the SEC, current Forms N-Q and N-SAR would be rescinded. Public comments must be received by the SEC on or before August 11, 2015.

RECENT SEC GUIDANCE FOR MUTUAL FUNDS

Cybersecurity Considerations

The staff of the SEC's Division of Investment Management ("Staff") published a Guidance Update titled "*Cybersecurity Guidance*" ("Update"). In this Update, the Staff highlights the importance of protecting confidential and sensitive information from third parties and discusses a number of measures that funds and advisers may wish to consider when addressing cybersecurity risks. In addition, the Staff observed that funds and advisers should:

- Identify their respective compliance obligations under the federal securities laws and take into account these obligations when assessing their ability to prevent, detect and respond to cyber attacks;
- Seek to mitigate exposure to any compliance risk associated with cyber threats through compliance policies and procedures that are reasonably designed to prevent violations of the federal securities laws; and
- Consider assessing whether protective cybersecurity measures are in place at relevant service providers.

Recognizing that "it is not possible for a fund or adviser to anticipate and prevent every cyber-attack", the Staff stated that "[a]ppropriate planning to address cybersecurity and a rapid response capability may, nevertheless, assist funds and advisers in mitigating the impact of any such attacks and any related effects on fund investors and advisory clients, as well as complying with the federal securities laws."

TOPICS IN THIS ISSUE:

FAQs on Valuation and Money Market Fund Reform

The Staff has released responses to select questions related to the guidance and reforms included in its final rule on money market reform adopted in July 2014 (the "Final Rule"). In a release titled "*Valuation Guidance Frequently Asked Questions*," the Staff responds to questions related to the valuation guidance for mutual fund portfolio holdings included in the Final Rule. In a second release titled "*2014 Money Market Fund Reform Frequently Asked Questions*," the Staff responds to questions related to the money market fund reforms included in the Final Rules. According to the releases, the Staff expects to update both documents from time to time to include responses to additional questions.

SEC INVESTMENT MANAGEMENT LEADERSHIP CHANGES

Grim Appointed Director of IM Division

The SEC has appointed David Grim Director of the Division of Investment Management. Mr. Grim joined the SEC as a Staff Attorney in the Office of Investment Company Regulation in September 1995, and was appointed Deputy Director of the Division of Investment Management in January 2013. He was named Acting Director in February 2015, following the departure of former Director Champ.

In a press release announcing the appointment, SEC Chair Mary Jo White stated that "David is a committed public servant with a nearly 20-year tenure in the Division of Investment Management. " and "I am confident that the Commission and the public will continue to benefit from his leadership and deep knowledge of the work of the division on behalf of investors."

Wyatt Succeeds Bowden As Director of OCIE

The SEC has selected Marc Wyatt to succeed Andrew Bowden as Acting Director of the Office of Compliance Inspections and Examinations ("OCIE"). Mr. Wyatt joined the SEC in 2012 as a senior specialized examiner, and had served as Deputy Director of OCIE since October 2014. Prior to joining the SEC, Mr. Wyatt served as a senior portfolio manager at a global multi-strategy hedge fund.

Northern Trust

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fund vehicles and domiciles, delivering the flexibility associated with a boutique administrator but with all the advantages of being one of the world's leading financial institutions.

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

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Regulatory Administration Digest is compiled by our Regulatory Administration Group.