INVESTMENT COMPANY INSTITUTE®

Securities Law Developments Webinar

Spotlight on the SEC: Developments Affecting Funds and Advisers

January 31, 2014

2:00–4:00 p.m. (ET)

Regulatory Developments Affecting the Fund Industry

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Money Market Mutual Fund Reform

Kevin Meagher

Senior Vice President, Deputy General Counsel

December 11, 2013

Fidelity INVESTMENTS

Alternative 1 - Floating NAV Overview and Issues

- Funds required to price and transact at $1.0000
  - Use of amortized cost accounting eliminated for all funds
- Scope of funds impacted
  - Government and Treasury funds exempted
  - Municipal and prime funds included
- Retail fund defined - $1 million daily redemption limit
  - Alternative – limit beneficial ownership interests to natural persons
- Tax concerns
  - IRS Wash Sale guidance
- Accounting questions
- Implementation period – proposed as two years

Alternative 2 – Fees / Gates Overview

- 2% liquidity fee automatically triggered at 15% Weekly Liquid Assets
  - Board has discretion to impose lower fee or no fee
  - Fee removed when fund recovers to 30% Weekly Liquid Assets
- Redemption gate may be triggered at 15% Weekly Liquid Assets
  - Board may impose temporary redemption gate
    - Gate must be lifted within 30 days
    - Cannot be imposed for more than 30 days in 90 day period
  - Gate automatically lifted once Weekly Liquid Assets at 30% and Board can lift at any time.
- Prompt public disclosure of Weekly Liquid Assets at 15%
- Implementation period – proposed as one year

Alternative 2 Issues

- Scope of funds
  - Government and Treasury funds exempted
  - Municipal and prime funds included
  - Retail definition does not apply
- Redemption fee - objective or subjective
- Board discretion for fee or gate
- Are fees/gates are a potential accelerant?
- Is 2% the appropriate fee?
- Gate time period
- Alternative 3 - combine Alternative 1 and Alternative 2

Comment Letter Responses

	Custom	Form	Total
Letters	149 (11%)	1,219 (89%)	1,368

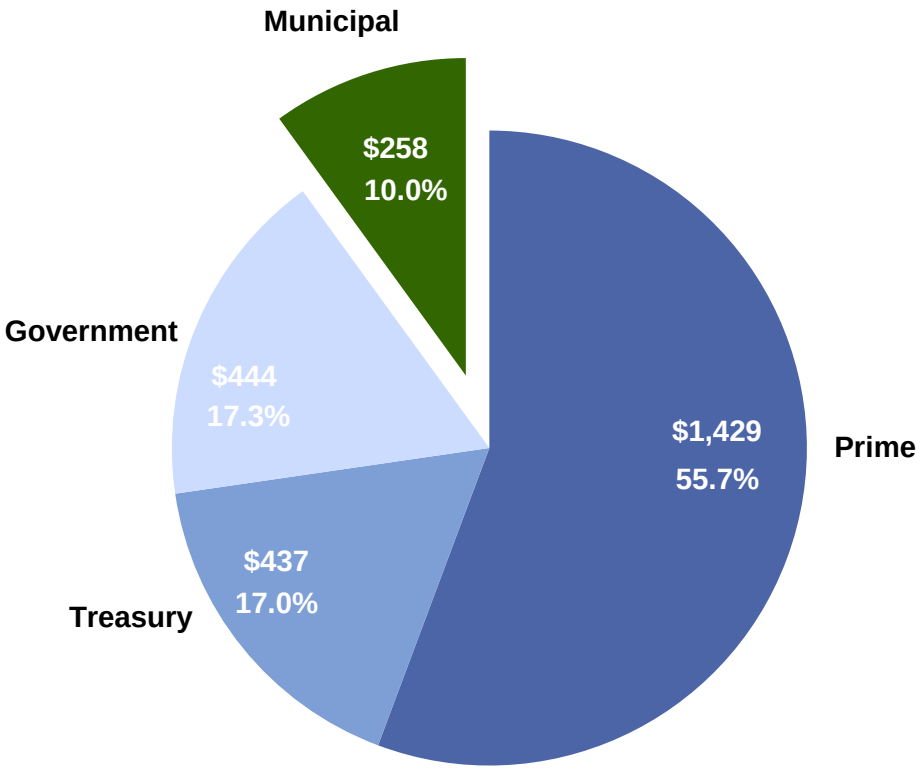
	Custom Letters		Form Letters	
	Mentions	Support	Mentions	Support
Alternative 1	91%	13%	100%	0%
Alternative 2	66%	33%	99%	97%
Gates Only	28%	34%	95%	100%
Alternative 3	34%	10%	--	--
Choice – 1 or 2	4%	50%	--	--
Exempt Muni	25%	68%	--	--
Exempt Retail	38%	65%	--	--

Sources: Fidelity and SEC as of 11/14/13

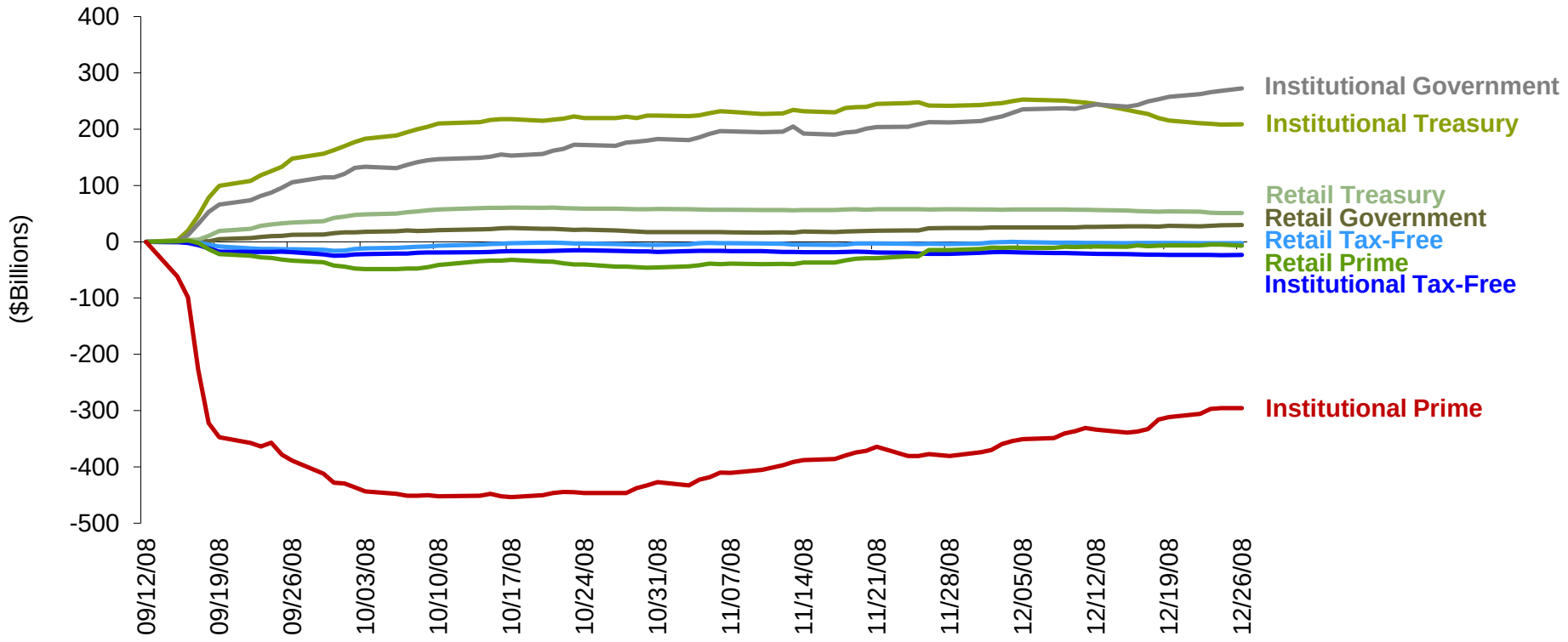
Fidelity INVESTMENTS

Size of Municipal MMFs is Not Systemic

MUNICIPAL MMF AS A PERCENT OF TOTAL MMF INDUSTRY
Total Assets $2,568 Billion



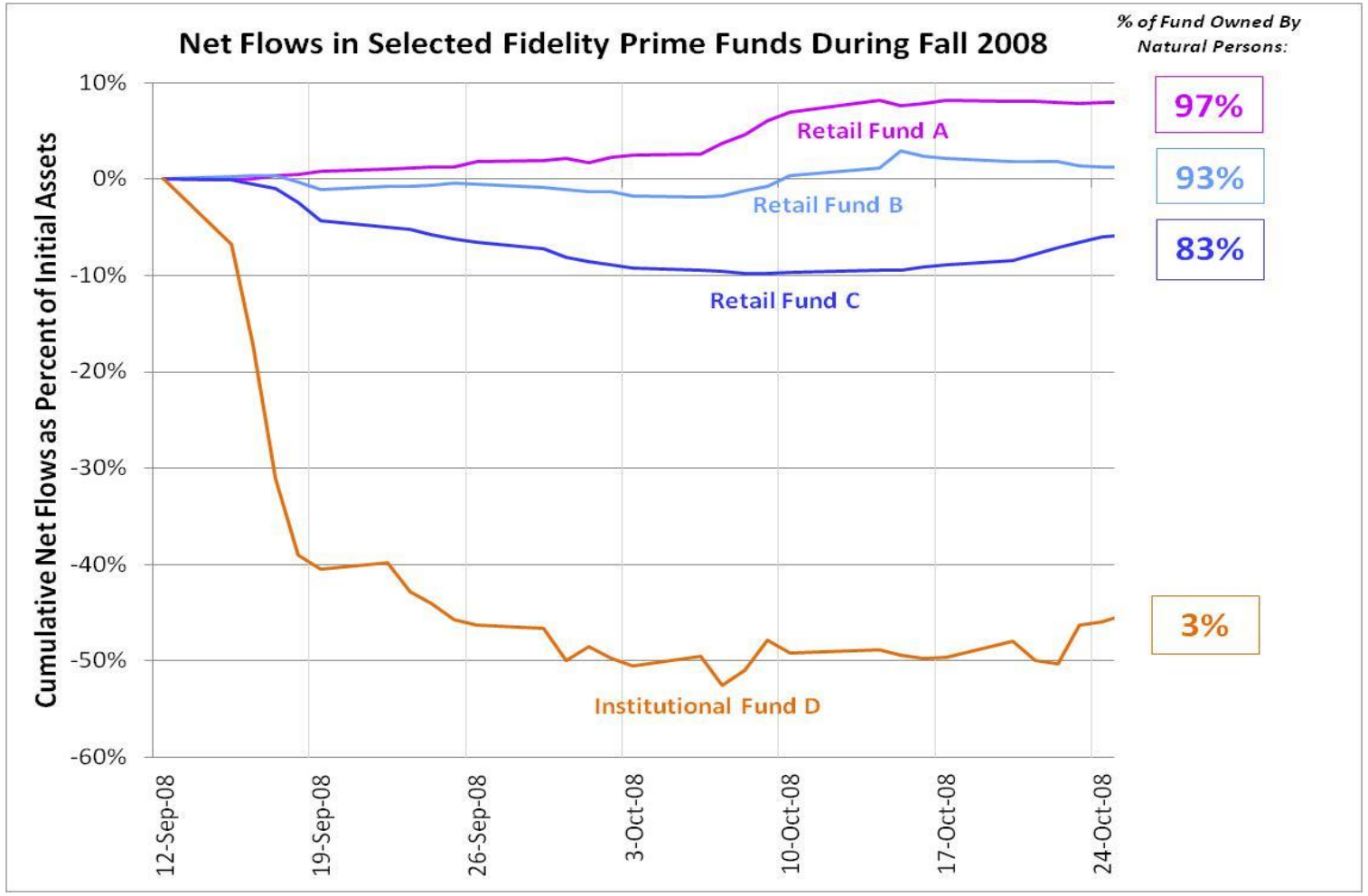
Money Market Mutual Fund Asset Flows - 2008



Source: iMoneyNet as of 07/29/13

Fidelity INVESTMENTS

Retail Fund Definition Based on Natural Persons



Source: Fidelity

Fidelity INVESTMENTS

OFR Asset Management Study

- Dodd Frank § 113 – Authority for FSOC to designate non-Bank SIFIs
  - "material financial distress . . . Or nature, scope, size, scale, concentration, favorite color . . . . Could pose threat to financial stability of the United States
  - Results in potential prudential supervision including capital requirements, leverage limits, liquidity requirements, resolution plans, disclosure requirements
  - Eleven statutory factors
  - Non-bank SIFI determinations so far: Prudential, AIG, GE Capital

- Dodd Frank § 120 – FSOC "may provide for more stringent regulation of a financial activity . . . [which] could create . . . Or increase the risk of significant liquidity, credit or other problems spreading . . . "
- Dodd Frank § 165 – details enhanced supervision and prudential standards for non-bank SIFIs

OFR Report

- FSOC commissioned Office of Financial Research to conduct study of asset management firms for assessment under Section 113
- Report focuses on risks arising from:
  - Reaching for yield
  - Herding behavior and attendant risk “transmission” and “acceleration”
  - Leverage
  - Firms as source of risk
  - Need for data
- Regulatory and industry response
  - Process Issues – no engagement of industry or primary regulator, superficial study
  - Inaccuracies and unsupported conclusions
  - Fails to take account of publicly available data
  - Frame of reference – does not address systemic significance
- Endgame concern -- § 120 – supplemental prudential regulation

Regulatory Developments Affecting the Fund Industry

Thomas S. Harman
Trina C. Hopkins
Bingham McCutchen LLP

I. Office of Financial Research Delivers Report on Asset Management Industry

1. Background

In September 2013, the U.S. Department of the Treasury's Office of Financial Research (the "OFR") delivered a report titled Asset Management and Financial Stability (the "Report") to the Financial Stability Oversight Council (the "FSOC") on ways that activities in the asset management industry might create, amplify, or transmit stress through the financial system. The OFR was created to provide data to regulators to help them identify risks to the financial markets. The OFR studied the activities of asset management firms and funds at the request of the FSOC, in connection with the FSOC's review of nonbank financial companies.

The purpose of the Report was to identify asset management industry activities that could pose risks to the financial stability of the United States.

2. The Report

A. Vulnerabilities and Threats to U.S. Financial Stability

The Report contains the OFR's opinion that the asset management industry may be vulnerable to financial shocks and may amplify and transmit such financial shocks, posing a threat to U.S. financial stability. It suggests that asset managers may be subject to increased scrutiny by the FSOC.

According to the Report, there are four categories of industry vulnerability:

i. "Reaching for Yield" and Herding Behaviors

The Report alleges that certain situations may lead portfolio managers to "reach for yield," or seek higher returns by purchasing relatively riskier assets that they otherwise would. It states that some asset managers may also crowd or "herd" into popular asset classes or securities regardless of the size or liquidity of that asset class or security. It states that these behaviors could contribute to increases in asset prices, as well as magnify market volatility and distress if the markets or market segments face a sudden shock.

ii. Redemption Risk in Collective Investment Vehicles

The Report states that collective investment vehicles offering unrestricted redemption rights could face the risk of large redemption requests in a stressed market if investors believe that they will gain an economic advantage by being the first to redeem. It also

states that asset sales in response to redemptions could spread stress from certain types of assets to other types of assets and market segments. It states that heightened redemptions could increase market risks if there is a perception that an asset manager itself is at risk of failure.

iii. Leverage, Which Can Amplify Asset Price Movements and Increase the Potential for Fire Sales

The Report states that the recent financial crisis illustrated that leverage, particularly short-term leverage, can subject borrowers to margin calls and liquidity constraints that increase the risk of "fire sales." It also notes that leverage through derivatives may magnify both gains and losses.

iv. Asset Managers as a Source of Risk

The Report alleges that the failure of a large asset manager could be a source of risk, depending on its size, complexity and the interaction among its various investment management strategies and activities. It states that distress at a large asset manager could amplify or transmit risks to other parts of the financial system. It notes that concentration of risks among funds or activities within a firm may pose a threat to financial stability, and that instability at a single asset manager could increase risks across the funds it manages or across markets throughout its combination of activities. It states that, in a variety of ways, risk managers at asset managers could fail to understand or anticipate risks with financial stability implications. The Report suggests that interconnectedness and complexity can transmit or amplify threats to financial stability.

B. Data

The Report contains certain types of data about the asset management industry and top asset managers. The Report noted, however, that significant gaps in available data about the asset management industry limited the OFR's ability to evaluate potential threats and their implications for financial stability. The OFR plans to continue working with the FSOC and its member agencies to further examine, prioritize and fill these data gaps.

C. SIFI Designation

In 2012, the FSOC issued a rule describing how it would designate certain non-bank financial companies as systemically important financial institutions ("SIFIs") and noting that it and the OFR were in the process of analyzing the extent to which asset management companies presented potential threats to financial stability. The rule left open significant questions about how asset managers would be evaluated under the SIFI designation process. The Report may provide insight into the designation process.

3. Comment Letters

The U.S. Securities and Exchange Commission (the "SEC") solicited comments on the Report, though the OFR did not. A number of comment letters have been filed, and comment letters to date about the Report have generally not been favorable, some letters going so far as to state that the Report presents an inaccurate and misleading picture of the asset management industry and has so many shortcomings that it should not serve as the basis for policy decisions or regulatory action and should be withdrawn. Some letters criticized the Report for its lack of supporting data. Some letters note that the Report, though limited and with incomplete data, does not expressly caution the reader regarding the conclusions that may be drawn based on such a limited review.

One letter offered data rebutting some of the conclusions in the Report, stating that during financial crises, capital preservation driven net withdrawals by mutual fund investors were always limited in magnitude, and atypical high redemptions were very short in duration. It also disagreed with the "herding" theory, noting that the mutual fund industry has never experienced harmonized redemption behavior.

Another letter asked the question -- under what conditions will additional regulation by the Fed of certain asset managers above and beyond specialist agencies, such as the SEC and U.S. Commodity Futures Trading Commission, actually remove threats to U.S. financial stability? It also noted that the Report is missing some key risks, as well as a list of aspects of the asset management industry that do not, in fact, pose a threat to financial stability.

Some letters expressed the concern that the findings of the Report, which consist of a general list of risks from which various hypothetical cause-and-effect scenarios are drawn, with little discussion of their likelihood, severity or possibility of correction, closely resemble the methodology that the FSOC has used in its three SIFI designation orders to date. The letters express the concern that the Report may provide the analytical foundation for the FSOC's future SIFI designations, notwithstanding the many criticisms of the Report.

II. SEC Proposes Money Market Fund Reform

1. Summary

On June 5, 2013, the SEC voted unanimously to propose additional changes to the regulation of money market funds. The SEC's proposal (the "Proposal"), which is lengthy and detailed, includes two key alternative changes along with a number of other reforms.

The Proposal suggests two fundamental amendments to Rule 2a-7 under the Investment Company Act of 1940 (the "1940 Act"). Each alternative could be adopted alone or in combination with the other. Under either alternative, all money market funds would be prohibited from using the amortized cost method to value their investments (except as permitted for all mutual funds in the case of securities maturing within 60 days). Instead, each money market fund would be required to calculate its net asset value per share ("NAV") using market prices on a daily basis and to disclose this information on its website. In addition, the Proposal would make certain other changes to existing regulations regardless of the alternative adopted.

2. The Proposal

A. Discontinued Use of Amortized Cost for All Money Market Funds

Currently, Rule 2a-7 permits a money market fund to value its portfolio using the amortized cost method. Regardless of the alternative adopted, the Proposal would prohibit all money market funds from using the amortized cost method of valuation (except to the extent permitted for all mutual funds). Instead, a money market fund would strike its NAV based on the market-based value of its portfolio.

B. Alternative 1 – Floating NAV for Non-Government Institutional Money Market Funds

Alternative 1 ("Alternative 1") would require a money market fund (other than "government" and "retail" money market funds) to "basis point round" (e.g., $1.0004 or $0.9997) its market-based NAV. In effect, Alternative 1 would require these funds to float their NAVs. However, "government" and "retail" money market funds could continue to penny round under Alternative 1, which would allow these funds' market-based NAVs to drop up to 50 basis points and still round to a NAV of $1.00.

"Government" money market funds would be exempt from the requirement of basis point rounding. As defined in the Proposal, government money market funds are those that invest at least 80% of their assets in cash, government securities, or repurchase agreements collateralized by government securities.

"Retail" money market funds would also be exempt from the requirement of basis point rounding. The Proposal defines retail money market funds as those funds that limit redemptions by any shareholder to no more than $1 million per business day.

Although municipal (or tax-exempt) money market funds are not specifically excluded from the requirement of basis point rounding, the Proposal notes that, because the tax advantages offered by these funds are enjoyed mainly by individuals, "most could continue to offer a stable share price" under the "retail" exemption.

The different treatment of "retail" funds and "institutional" funds, as proposed, would effectively prohibit a money market fund from offering separate share classes for retail and institutional investors. The Proposal acknowledges that, if a fund wishes to offer a stable NAV to retail investors while allowing redemptions for institutional investors above the $1 million daily limit, the fund must reorganize the share classes into separate funds.

C. Alternative 2 – Liquidity Fees and Redemption Gates

Under alternative 2 ("Alternative 2:), money market funds would be required to impose a 2% liquidity fee (unless its board determined that a liquidity fee was not in the fund's best interest, or a lower liquidity fee was in the fund's best interest) and would also have the ability to impose redemption gates, in either case if a fund's "weekly liquid assets" fell below 15% of the fund's

total assets. Under Alternative 2, fund boards would be faced with significant new responsibilities in times of stress, as discussed in greater detail below.

Under Alternative 2, as in the case of Alternative 1, money market funds would not be permitted to use the amortized cost method of accounting (except as permitted for all mutual funds as noted above), but, unless the SEC also adopts Alternative 1, they would be permitted to penny round (e.g., to $1.00).

The 2% liquidity fee would be imposed on all redemptions commencing with the business day following the day on which the fund's level of "weekly liquid assets" falls below 15% of its total assets. (Rule 2a-7 requires a money market fund to maintain weekly liquid assets of at least 30% of the fund's total assets.) However, such a fee would not be imposed if the fund's board (including a majority of the independent board members) determines that such a fee is not in the best interest of the fund or that a lower liquidity fee is in the best interest of the fund. The Proposal also expects the board's decision on whether to impose a liquidity fee or gate to take account of how soon securities in the fund's portfolio are expected to mature and whether a drop in the market- based NAV of the fund accompanied the drop in liquidity.

"Weekly liquid assets" generally include cash, U.S. Treasury securities, certain other government securities with remaining maturities of 60 days or less, and securities that convert into cash within one week.

In addition to the liquidity fee, a fund's board would also have the flexibility to impose a temporary suspension of redemptions (a "gate") for a fund with weekly liquid assets of less than 15%. A money market fund that imposed a gate would, except as noted below, need to lift that gate within 30 days, although the board could determine to lift the gate earlier. Money market funds would not be able to impose a gate for more than 30 days in any 90-day period.

The Proposal would require that any fee or gate be lifted automatically once the fund's weekly liquid assets have risen back above the required 30% level. Moreover, a fund's board could determine to lift the fee or gate even before the fund reaches the 30% level.

Alternative 2 would require the prompt and public disclosure (on a new SEC form, as discussed below) when a fund falls below the 15% weekly liquid asset threshold or imposes or removes any liquidity fee or gate, and a discussion of the board's analysis in determining whether or not to impose a fee or gate.

Alternative 2 would also amend Rule 22e-3 to permit (but not require) the permanent suspension of redemptions and liquidation of a money market fund if the fund's level of weekly liquid assets falls below 15% of its total assets. This would allow a money market fund that imposes a fee or a gate, but determines that it would not be in the best interest of the fund to continue operating, to suspend redemptions permanently and to liquidate.

Government money market funds would be exempt from any fee or gate requirement but would be permitted to impose such a fee or gate under the regime described above if the ability to impose such fees and gates were disclosed in the fund's prospectus.

D. Combination of Both Principal Reforms

The Proposal makes clear that the SEC will also consider implementing both of the principal reform alternatives. Under this regime, non-government institutional money market funds would be required to transact at a floating NAV, and all non-government money market funds would be required to impose liquidity fees and would be able to impose gates in certain circumstances.

E. Other Proposed Reforms

The Proposal includes additional disclosure and diversification measures that would apply regardless of whether the SEC adopts Alternative 1, Alternative 2, or both.

i. Website Disclosure

The Proposal would require money market funds to disclose on their website, on a daily basis, their levels of daily and weekly liquid assets and market-based NAVs. Although not currently required, many money market funds have recently started to disclose their daily market-based NAVs on their websites.

ii. New Form N-CR – Material Event Disclosure

Money market funds would be required to promptly disclose certain events on a new form (Form N-CR). These events would include the imposition or lifting of fees or gates, portfolio security defaults, sponsor support, and – for funds that would continue to maintain a stable share price under either principal alternative – a decrease in the fund's market-based NAV below $0.9975.

iii. Revised Form N-MFP

The Proposal would amend Form N-MFP to require the reporting of additional information relevant to assessing money market fund risk, and would make the information filed on Form N-MFP publicly available immediately upon filing. The information filed on Form N-MFP is currently made available to the public on a 60-day delay.

iv. Revised Form PF

The Proposal would amend Form PF, which private fund advisers currently use to report information about certain private funds they advise, to include information to help the SEC monitor asset migration from registered money market funds to private liquidity funds in response to the reforms. Advisers managing at least $1 billion in combined money market fund and liquidity fund assets would be required to report substantially the same portfolio information on Form PF as registered money market funds would report on Form N-MFP.

v. Disclosure of Historical Sponsor Support

The Proposal would require money market funds to disclose historic instances of sponsor support for money market funds in a fund's statement of additional information. The Proposal would require each money market fund to disclose any occasion during the previous ten years (not including events that have occurred before the rule's compliance date) on which an affiliated person, promoter, or principal underwriter of the fund, or an affiliated person of such person, provided any form of financial support to the fund. With respect to each such occasion, the fund would have to describe the nature of support, the amount of support, the date the support was provided, the security supported and its value on the date the support was initiated (if applicable), the reason for the support, the term of support (if applicable), and any contractual restrictions relating to the support.

vi. Stronger Diversification Requirements

Money market funds currently may not invest more than 5% of their assets in any one issuer. The Proposal would expand the notion of "issuer" for this purpose to include affiliates of the issuer, as specifically defined. Thus, money market funds would be restricted from investing more than 5% of their assets in any affiliated group for purposes of complying with this limit.

Money market funds currently must generally limit their investments in securities subject to a demand feature or a guarantee from any one provider to no more than 10% of fund assets, except that a 25% "basket" of securities may be subject to demand features or guarantees from a single institution. The Proposal would remove the 25% "basket."

As noted, money market funds currently must generally limit their investments in securities subject to a demand feature or a guarantee to no more than 10% of fund assets with any one demand feature or guarantee provider. When making this calculation, the Proposal would require money market funds to treat the sponsors of certain asset-backed securities as guarantors subject to the 10% limit. However, this would not be necessary if the money market fund's board of directors (or its delegate) determines that the fund is not relying on the asset- backed security's sponsor's financial strength or its ability or willingness to provide liquidity, credit, or other support to determine the asset-backed security's quality or liquidity.

vii. Enhanced Stress Testing

Under the Proposal, a money market fund's stress testing requirements would be required to include a stress test against, among other things, the fund's weekly liquid assets falling below 15% of total assets. In addition, the SEC is proposing to strengthen the manner in which money market funds stress test their portfolios and report the results of their stress tests to their boards.

3. Comment Letters

The Proposal has generated numerous detailed comment letters, including over 1,000 form letters against Alternative 1. The letters generally did not support Alternative 1 or Alternative 2 as proposed, with some letters implying that a combination of the two would devastate the industry. Some letters stated that Alternative 2 was the preferable choice to Alternative 1. Some letters offered suggested modifications to Alternative 1 and Alternative 2. Some letters expressed the view that the money market fund reforms adopted by the SEC in 2010 were sufficient. Some letters proposed alternative definitions of "retail fund" or asked that the Proposal exclude tax-exempt money market funds.

4. Speeches

In an open meeting of the SEC on June 5, 2103, SEC Chair Mary Jo White noted that the 2010 money market reforms were only a first step. She stated that the Proposal takes the critical additional step of addressing the stable value pricing of institutional prime funds, which was at the heart of the 2008 run, and proposes methods to stop a money market fund run before such a run becomes a systemically destabilizing event. She recounted the journey that has taken place to reach this point. She stated that the SEC staff has spent years studying different reform alternatives and performing extensive economic analysis in arriving at these recommendations. She stated that she believes that Alternative 1 is important for a number of reasons:

- First, by eliminating the ability of early redeemers to receive $1.00 - even when the fund has experienced a loss and its shares are worth somewhat less -- Alternative 1 should reduce incentives for shareholders to redeem from institutional prime money market funds in times of stress.
- Second, Alternative 1 increases transparency and highlights investment risk because shareholders would experience price changes as an institutional prime money market fund's value fluctuates.
- Finally, Alternative 1 is targeted, by focusing reform on the segment of the market that experienced the run in the financial crisis.

She then went on to note that Alternative 2 potentially could enhance the SEC's regulation in several ways:

- First, it could more equitably allocate liquidity risk by assigning liquidity costs in times of stress (when liquidity is expensive) to redeeming shareholders -- the ones who create the liquidity costs and disruption.
- Second, Alternative 2 would provide new tools to allow funds to better manage redemptions in times of stress, and thereby potentially prevent harmful contagion effects on investors, other funds, and the broader markets. If the beginning of a run or significantly heightened redemptions occur, they would no longer continue unchecked, potentially spiraling into a crisis. The imposition of liquidity fees or gates would be an available tool to directly counteract a run.

- And, third, Alternative 2 is also targeted, focusing the potential limitations on a money market fund investor's experience to times of stress when unfettered liquidity can have real costs.

III. Latest Developments in Valuation

1. Morgan Keegan

A. Summary

On December 10, 2012, the SEC initiated an action against the directors of five registered investment companies advised by Morgan Keegan, alleging that they had failed to satisfy their valuation and other obligations in violation of Rules 22c-1, 30a-3(a) and 38a-1 under the 1940 Act. On June 13, 2013, the SEC issued a cease and desist order (the "Order") against the directors in settlement of the administrative proceedings (IC-30557).

The SEC and other regulators had previously charged the funds' investment advisers with fraud, and the firms later agreed to pay $200 million to settle the charges. In addition, two Morgan Keegan employees also agreed to pay penalties for their alleged misconduct, and one was barred from the securities industry.

B. The Order

The action against the directors alleged that the funds, which were invested in securities backed by subprime mortgages, fraudulently overstated the value of their securities during much of 2007. The Order alleged that (i) the directors delegated their fair valuation responsibility to a valuation committee without providing meaningful substantive guidance on how fair valuation determinations should be made, (ii) the fund directors then made no meaningful effort to learn how fair values were being determined, and (iii) the fund directors received only limited information about the factors involved with the funds' fair value determinations, and obtained almost no information explaining why particular fair values were assigned to particular portfolio securities.

The Order alleged that the directors caused the funds to violate the federal securities laws by failing to adopt and implement meaningful fair valuation methodologies and procedures, and by failing to maintain adequate internal controls over financial reporting. For example, the Order alleged that the funds' valuation procedures did not include any mechanism for identifying and reviewing fair-valued securities, the prices of which remained unchanged for weeks, months, and even entire quarters.

According to the Order, the funds' valuation procedures required that the directors be given explanatory notes for the fair values assigned to securities. However, it was alleged that no such notes were ever provided to the directors, and they never followed up to request such notes or any other specific information about the basis for the assigned fair values. The Order further alleged that Morgan Keegan's Fund Accounting unit, which assigned values to the securities, did not utilize reasonable procedures and often allowed the portfolio manager of the relevant fund to

arbitrarily set values. As a result, the net asset values of the funds allegedly were materially misstated in 2007 from at least March 31 to August 9. Finally, the Order alleged that the prices at which one open-end fund sold, redeemed, and repurchased its shares were inaccurate, and other reports and at least one registration statement contained net asset values that were materially misstated.

In particular, the Order stated:

> "In connection with determining fair values, the Directors did not calculate the valuations themselves, and neither established clear and specific valuation methodologies nor followed up their general guidance to review and approve the actual methodologies used and the resulting valuations. Instead, they approved policies generally describing the factors to be considered but failed to determine what was actually being done to implement those policies. As a result, Fund Accounting implemented deficient procedures, effectively allowing the Portfolio Manager to determine valuations without a reasonable basis. In this regard, the Directors failed to exercise their responsibilities with regard to the adoption and implementation by the Funds of procedures reasonably designed to prevent violations of the federal securities laws."

C. Specific Violations

The Order found that the directors caused the funds to violate Rule 38a-1 under the 1940 Act, which requires funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. Specifically, the SEC found that (i) the directors delegated their fair valuation responsibility to a valuation committee without providing adequate substantive guidance on how fair valuation determinations should be made, (ii) the directors then made no meaningful effort to learn how fair values were being determined, (iii) the directors received only limited information about the factors involved with the funds' fair value determinations, and obtained almost no information explaining why particular fair values were assigned to portfolio securities, and (iv) the limited information provided to the directors was particularly problematic because fair valued securities comprised a significant percentage of the funds' net asset values - in most cases above 60 percent.

The Order found that the valuation committee to whom the directors delegated the fair valuation responsibilities did not utilize reasonable procedures and often allowed the portfolio manager to arbitrarily set values. As a result, the Order found that the funds overstated the value of their securities from January 2007 until August 2007.

The directors consented to the entry of the Order without admitting or denying any of the findings.

2. SEC Focus on Valuation

The SEC's Office of Compliance Inspections and Examinations National Exam Program report ("Examination Priorities for 2013") states that the SEC's examination staff will confirm that

advisers are making full and accurate disclosures to fund boards and that fund directors are conducting reasonable reviews of such information in connection with the valuation of fund assets. To that end, in the press release announcing the Morgan Keegan settlement, George S. Canellos, Co-Director of the SEC's Division of Enforcement stated, "[o]ur settlement sends a clear warning of our commitment to enforce the duty of mutual fund directors and trustees to closely oversee the process of valuing securities held by their funds."

2013 Securities Law Developments Conference

Transitioning to the New Swap Regulatory Framework: Current and Upcoming Challenges

December 11, 2013

Panelists

Gary Barnett
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Panel Agenda

- Current Status of Title VII Rulemakings
- Swap Reporting
- Clearing, Margin, and Treatment of Collateral
- Trading
- Cross-Border Swaps Transactions
- Audience Questions

Current Status of Title VII Rulemakings

- Status of CFTC and SEC rulemakings under Title VII of the Dodd-Frank Act
- Compliance implications

Swap Reporting

- Reporting obligations under Title VII
- Re-proposed rules on position limits

Clearing, Margin, and Treatment of Collateral

- Mandatory clearing of swaps
- Margin requirements

Clearing, Margin, and Treatment of Collateral

- Treatment of collateral
  - CFTC
    - Customer protection rules
    - “LSOC” (“legally segregated, operationally commingled”) rules
      - “LSOC plus excess”
    - Uncleared swap collateral

Clearing, Margin, and Treatment of Collateral

- SEC
  - Capital, margin, and segregation proposal

Trading

- Swap execution facilities ("SEFs") and designated contract markets ("DCMs")
  - Mandatory trading: "available to trade" determination
- Issues raised by SEF rulebooks and user agreements
- Recordkeeping issues
- Trade documentation

Cross-Border Swaps Transactions

- Overview of regulatory approaches:
  - CFTC
  - SEC
  - European Market Infrastructure Regulation ("EMIR")
- Remaining issues and potential conflicts

Transitioning to the New Swap Regulatory Framework: Current and Upcoming Challenges*

Investment Company Institute's
2013 Securities Law Developments Conference
December 11, 2013

M. Holland West and Philip T. Hinkle**

Dechert LLP

* Published on November 25, 2013.
** Holland West (New York) and Phil Hinkle (Washington D.C.) focus on public and private fund, commodity, and derivative transaction and regulatory matters. Assistance provided by Matthew S. Virag (New York).

TABLE OF CONTENTS

Page

I. INTRODUCTION AND OVERVIEW OF DODD-FRANK

Title VII of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act ("Title VII" or "Dodd-Frank"), enacted on July 21, 2010, provided for the first time a comprehensive regulatory framework for the over-the-counter ("OTC") derivatives markets. Fundamentally, Title VII aimed to prevent future financial crises by mandating robust market and transaction level transparency while reducing structural leverage and systemic risk throughout the derivatives markets.

Title VII codifies the global de-risking process underway since the 2008-2009 financial crisis with particular focus on:

- reducing counterparty risk and enhancing transparency and price discovery by requiring clearing and exchange trading of eligible derivatives contracts;

- deleveraging the OTC derivatives markets by imposing new regulatory capital and margin requirements on OTC swap dealers ("swap dealers") and certain large OTC swap participants ("major swap participants");

- requiring swap dealers and major swap participants to register with the U.S. Securities and Exchange Commission ("SEC") and/or the U.S. Commodity Futures Trading Commission ("CFTC") and to continuously disclose detailed information regarding their derivatives trading activities; and

- prohibiting U.S. Federal guarantees and other Federal assistance from being provided to insured depository institutions involved in the swap markets, subject to exceptions for affiliated swap dealers and certain swap activities related to *bona fide* hedging and traditional bank activities.

Certain regulations promulgated by the CFTC under Dodd-Frank can be conceptually divided into entity-level requirements which apply to certain market participants without distinction as to the counterparty or location of the swap, and transaction-level requirements that apply to each swap.

- "Entity-Level Requirements" relate to: (i) capital adequacy; (ii) chief compliance officer; (iii) risk management; (iv) swap data recordkeeping; (v) swap data reporting; and (vi) physical commodity swap reporting (*i.e.*, swap large trader reporting).

- "Transaction-Level Requirements" relate to: (i) clearing and swap processing; (ii) margining (and segregation) for uncleared swaps; (iii) trade execution; (iv) swap trading relationship documentation; (v) portfolio reconciliation and compression; (vi) real-time public reporting; (vii) trade confirmation; (viii) daily trading records; and (ix) external business conduct standards.

Certain portions of Title VII remain subject to further rulemaking by the SEC and the CFTC.

II. JURISDICTION UNDER TITLE VII

Dodd-Frank allocates jurisdiction over the derivatives markets between the SEC for "security-based swaps" and certain participants in the security-based swap markets and the CFTC for all other "swaps" and certain participants in the swap markets. The SEC is the regulatory authority responsible for imposing new capital and margin requirements on security-based swaps, such as equity swaps, forwards, and options, and the CFTC has analogous authority over all swaps other than security-based swaps, such as commodity swaps, forwards, and options (in addition to futures contracts, options on futures, and commodity options, which are already regulated by the CFTC).

(a) Derivative Contracts that are Commodities vs. Securities

The following chart identifies broad categories of transactions that are "commodity interests"[1] subject to CFTC jurisdiction and "securities"[2] subject to SEC jurisdiction.

Derivatives Contract	Commodity	Security
Commodity futures including security futures (on single stocks, narrow-based securities indices,[3] and broad-based securities indices)	**X**	
Options on commodities	**X**	
Options on commodity futures	**X**	
Options on securities that settle into the security		**X**
Options on security futures that settle into a futures contract	**X**	
Swaps on individual securities, single loans (non-security loans),[4] or narrow-based security indices		**X**
Swaps on broad-based securities indices	**X**	

(b) Swaps vs. Non-Swaps

Dodd-Frank broadens the definition of "swap" and places swaps under CFTC jurisdiction. The charts below provide examples of swaps and non-swaps under Section 1a(47) of the U.S. Commodity Exchange Act as amended ("CEA") and the CFTC regulations thereunder.

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1 CEA Section 4m(3)(C); CFTC Regulation 1.3(yy).

2 Section 2(a)(1) of the U.S. Securities Act of 1933 as amended and Section 3(a)(10) of the U.S. Securities Exchange Act of 1934 as amended ("Exchange Act").

3 A narrow-based securities index generally contains nine or fewer component securities. CEA Section 1a(35); Exchange Act Section 3(a)(55)(B).

4 "Depending on the facts and circumstances loans may be notes or evidences of indebtedness that are securities" under Section 3(a)(10) of the Exchange Act. *See Further Definition of "Swap,'' "Security-Based Swap,'' and "Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule*, 77 Fed. Reg. 48208, 48266 n.662 (Aug. 13, 2012) (citing Section 3(a)(10) of the Exchange Act). A security-based swap is defined in CEA Section 1a(42) and Exchange Act Section 3(a)(68).

Financial Product	Swap	Non-Swap
Foreign Exchange Products:		
Foreign Exchange Forwards[5]		**X**
Foreign Exchange Swaps[6]		**X**
Foreign Currency Options	**X**	
Retail Foreign Currency Options		**X**
Non-Deliverable Forward Contracts Involving Foreign Exchange	**X**	
Currency Swaps and Cross- Currency Swaps	**X**	
Foreign Exchange Options Traded on a National Securities Exchange		**X**
Forward Rate Agreements	**X**	
Combinations and Permutations:		
"Swaptions"	**X**	
Forward Swaps	**X**	
Mixed Swaps[7]	**X**	
Contracts for Differences	**X**	

Although not generally regulated as swaps, certain non-swaps (including physically-settled foreign exchange swaps and foreign exchange forwards) are subject to the CFTC's business conduct, regulatory reporting, anti-fraud, and anti-manipulation rules as well as the CFTC's existing jurisdiction over retail transactions.[8]

The following transactions, except for certain guarantees of swaps as described below, fall outside of the definitions of swap and security-based swap and are thus not regulated by the CFTC or the SEC.

Financial Product	Additional Information	Swap	Non-Swap
Guarantees of Swaps	Considered swaps to the extent that a counterparty to a swap position would have recourse to the guarantor in	**X**	

5 Under CEA Section 1a(24), a "foreign exchange forward" is narrowly defined as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange."

6 Under CEA Section 1a(25), a "foreign exchange swap" is narrowly defined as "a transaction that solely involves—(A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of [those 2 currencies] at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."

7 Under CEA Section 1a(47)(D), a "mixed swap" is a security-based swap that is also "based on the value of one or more interest or other rates, currencies, commodities, instruments of indebtedness, indices, quantitative measures, other financial or economic interest or property of any kind (other than a single security or a narrow-based security index), or the occurrence, non-occurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."

8 *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act*, 77 Fed. Reg. 69694, 69699 (Nov. 20, 2012); CEA Sections 1a(47)(E) and (F)(ii).

Financial Product	Additional Information	Swap	Non-Swap
	connection with the position.		
Insurance Products	Must meet "Product Test"[9] and "Provider Test"[10] to be considered insurance and not swaps. Those products listed as "Traditional Insurance Products" must be provided in accordance with the Provider Test.		**X**
Consumer Transactions	Transactions entered into by consumers (natural persons) as principals (or by their agents) primarily for personal, family, or household purposes.		**X**
Commercial Transactions	Customary business arrangements (whether or not involving a for-profit entity).		**X**
Loan Participations	Purchaser acquiring a current or future direct or indirect ownership interest in the related loan or commitment.		**X**

[9] To satisfy the Product Test:

- the beneficiary of the agreement, contract, or transaction must carry the risk of loss with respect to an insurable interest continuously throughout the duration of the agreement, contract, or transaction;
- the agreement, contract, or transaction must require a proof of loss and limit any payment or indemnification to the value of the insurable interest;
- the agreement, contract, or transaction cannot be traded, separately from the insured interest, on an organized or OTC market; and
- with respect to financial guaranty insurance policies only, any acceleration of payment must be at the sole discretion of the provider.

CFTC Regulation 1.3(xxx)(4)(i)(A); Exchange Act Rule 3a69-1(a)(1).

[10] To satisfy the Provider Test, an agreement, contract, or transaction must be:

- provided by a person subject to supervision by either the insurance commissioner of any state or the United States, and applicable state or federal law must regulate any such agreement, contract, or transaction as insurance;
- directly or indirectly issued by the United States, any state, or any of their respective agencies, instrumentalities, or pursuant to a statutorily authorized program thereof;
- for reinsurance only, issued by a person to another "eligible provider," so long as (i) the person offering reinsurance is not prohibited from doing so by applicable state or federal laws, (ii) the reinsurance agreement, contract, or transaction passes the Product Test or is an "Enumerated Product," and (iii) the total amount reimbursable by all reinsurers does not exceed the claims or losses paid by the person transferring the risk to the reinsurer, except as permitted under applicable state law; or
- for non-admitted insurance only, issued by a person who (i) is located outside the United States and is listed on the "Quarterly Listing of Alien Insurers," or (ii) meets the eligibility criteria for non-admitted insurers under applicable state law.

CFTC Regulation 1.3(xxx)(4)(i)(B); Exchange Act Rule 3a69-1(a)(2).

Financial Product	Additional Information	Swap	Non-Swap
Forward Contracts in Nonfinancial Commodities	Commercial market participants that regularly make or take delivery of the referenced commodity through a separately negotiated agreement.		**X**

III. IMPLEMENTATION OF TITLE VII AND RELATED ISSUES

(a) Mandatory Clearing of Swaps

(i) Clearing Requirement and Submission of Swaps for Clearing

Title VII amended the CEA to require clearing of all swap transactions that are acceptable to a derivatives clearing organization ("DCO") for clearing, other than any swap for which one of the counterparties is a "commercial end-user."[11] The CFTC has adopted Regulation 50.2 to implement the CEA clearing requirement. Timing of any clearing obligation depends on (i) authorization of clearinghouses and (ii) authorization of products for clearing. Currently there are 13 registered DCOs (*i.e.*, clearinghouses) and three more pending.

The CFTC is required to designate products as subject to mandatory clearing (i) in response to requests by DCOs with respect to products currently cleared by such DCOs, and/or (ii) on its own initiative.[12]

- A DCO must submit to the CFTC for prior approval any group, category, type, or class of swaps the DCO seeks to clear.[13] The CFTC is required to respond to any such DCO request within 90 days of submission of the request.[14]

- Additionally, the CFTC is required to review swaps that have not been accepted for clearing by a DCO on an ongoing basis, and may determine on its own initiative that such swaps should be required to be cleared.[15]

In making these determinations, the CFTC will review all relevant facts and circumstances, issue a public report containing the results of the determination within 30 days of its completion, and take any action the CFTC determines necessary and in the public interest.[16] To be cleared, a product must be on standard terms, trade in volume, and be sufficiently liquid.

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11 CEA Section 2(h).

12 CEA Section 2(h)(2).

13 CEA Section 2(h)(2)(B)(i); CFTC Regulation 39.5(b).

14 CEA Section 2(h)(2)(C); CFTC Regulation 39.5(b)(6).

15 CEA Section 2(h)(2)(A); CFTC Regulation 39.5(c).

16 CFTC Regulation 39.5(c)(i)-(iii).

(ii) Categories of Swaps Subject to Mandatory Clearing

The CFTC made its first mandatory clearing designations on November 28, 2012 and determined that certain interest rate swaps and certain credit default swaps are subject to mandatory clearing.[17] Current designations include:

- Interest Rate Swaps ("IRS"): Basis Swaps, Fixed-to-Floating Swaps, and Forward Rate Agreements in U.S. Dollars, Euro, Pounds Sterling, and Japanese Yen, and Overnight Index Swaps in U.S. Dollars, Euro, and Pounds Sterling.[18]

- Credit Default Swaps ("CDS"): Untranched CDS on CDXNA.IG and CDXNA.HY North American Indexes and iTraxx Europe, iTraxx Europe Crossover, and iTraxx Europe HiVol.[19]

(iii) Implementation Schedule for Cleared Swaps

CFTC Regulation 50.25 divides market participants into three categories with staggered compliance dates for clearing mandates:

- *Category 1 Entities:* Registered swap dealers, registered major swap participants, and active funds.[20] Swaps between Category 1 entities must comply within 90 days after a mandatory clearing designation.

- *Category 2 Entities:* Commodity pools, private funds other than active funds, and persons predominantly engaged in the business of banking or in activities that are financial in nature as defined in Section 4(k) of the U.S. Bank Holding Company Act of 1956 as amended, provided that, in each case, the entity is not a third party subaccount. Registered investment companies engaging in swap transactions are Category 2 entities. Swaps between a Category 1 entity and a Category 2 entity, or between two Category 2 entities, must comply within 180 days after a mandatory clearing designation.

- *All other entities:* Swaps between all other entities must comply within 270 days after a mandatory clearing designation.

The following chart sets forth the standard implementation schedule under CFTC Regulation 50.25 for future mandatory clearing of additional categories of swaps covered by a CFTC clearing determination (assuming hypothetically and for simplicity that the next mandatory clearing determination is made on January 1, 2014).

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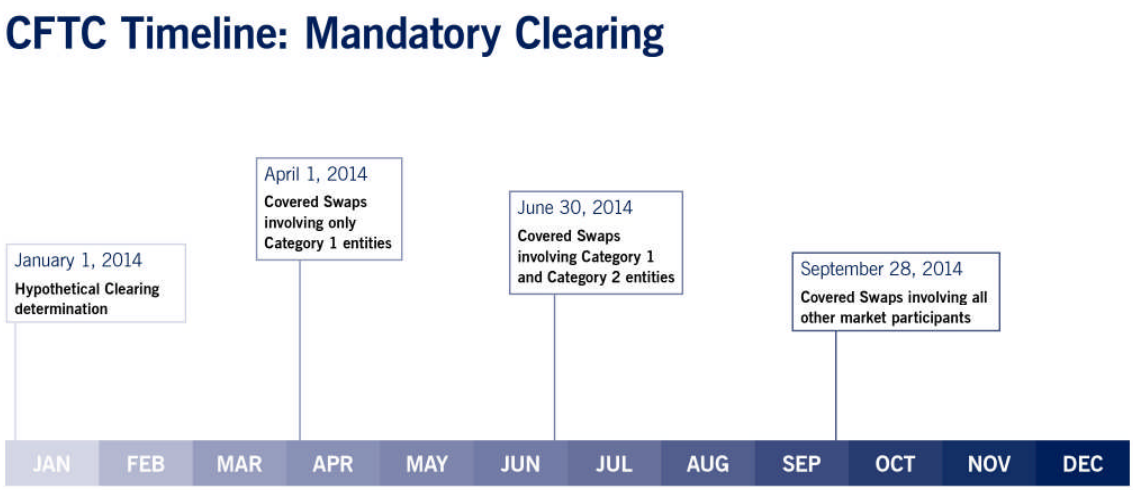
17 *Clearing Requirement Determination Under Section 2(h) of the CEA; Final Rule*, 77 Fed. Reg. 74283 (Dec. 13, 2012); CFTC Regulation 50.4.

18 CFTC Regulation 50.4(a).

19 CFTC Regulation 50.4(b).

20 An "active fund" is any private fund as defined in Section 202(a) of the U.S. Investment Advisers Act of 1940 as amended that is not a third party subaccount and that executes more than 200 swaps per month.

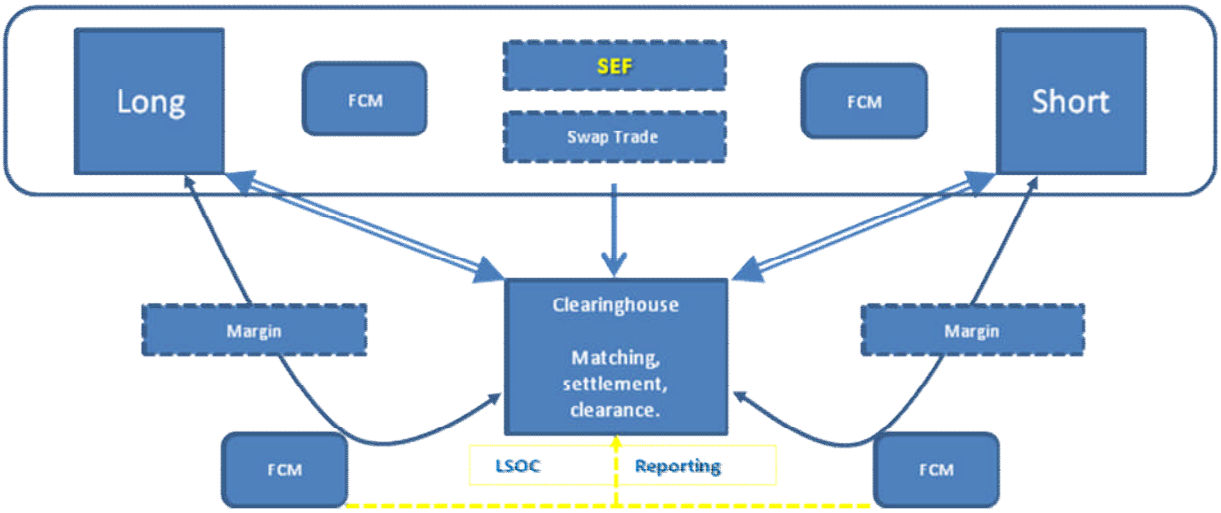


(iv) Clearing Process

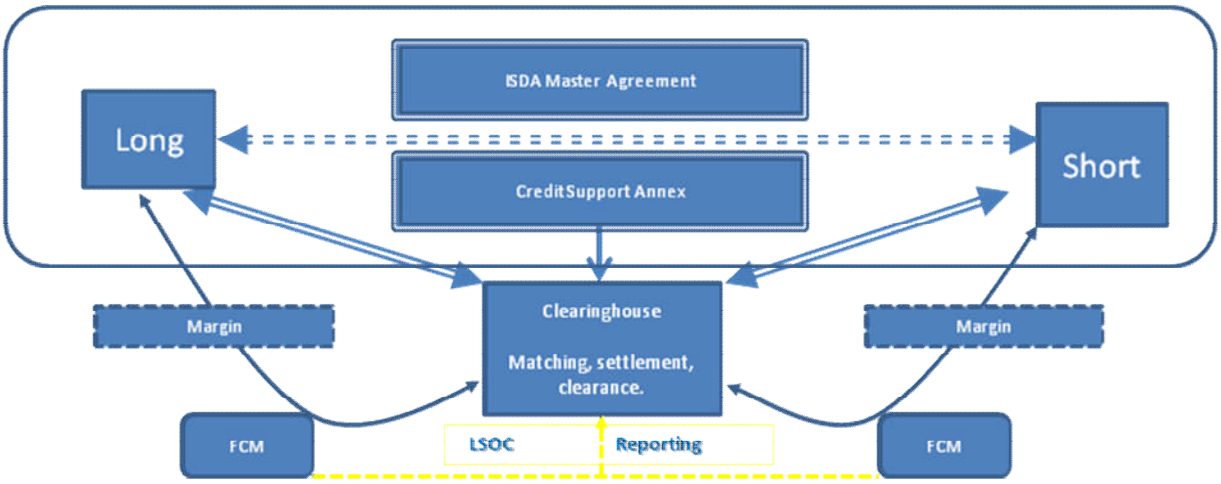
Cleared swaps may be exchange traded or traded bilaterally OTC. Futures commission merchants ("FCMs") facilitate clearing of both exchange-traded and bilateral OTC swaps. An FCM is an individual or organization that (i) solicits or accepts orders to buy or sell futures contracts, options on futures contracts, commodity options, retail off-exchange forex contracts, or swaps, and (ii) accepts money or other assets from customers to support such orders.[21]

For an *on-exchange swap transaction*, a party executes a swap with another party on an exchange either directly (as a swap execution facility ("SEF") member) or through an FCM. The DCO (*i.e.*, clearinghouse) then steps between each party to the exchange-traded swap to be the universal counterparty. Each party faces the DCO through the party's respective clearing FCM, which posts margin and makes payments for all of its clients to the DCO on an aggregate basis (subject to certain customer protection rules, discussed herein). The following graphic depicts the process for clearing of exchange-traded swaps.

[21] CEA Section 1a(28).



For an *OTC cleared swap transaction*, the buy-side participant (*e.g.*, a fund) and a swap dealer or other permissible counterparty execute a swap OTC directly and bilaterally and document the swap transaction under an International Swaps and Derivatives Association ("ISDA") Master Agreement. Following execution, the parties "give up" the swap transaction for clearing through their respective clearing member FCMs. As in an on-exchange swap, after the trade is submitted through an FCM to a DCO for clearing, each party faces the DCO as the universal counterparty through a clearing FCM. The FCM posts margin and makes payments for all of its clients to the DCO on an aggregate basis. The following graphic depicts the process for clearing of OTC swaps.



For *both exchange-traded and OTC cleared swaps*, the DCO requires both "initial margin" (*i.e.*, a performance bond) and "variation margin" (*i.e.*, exposure margin based on market moves and volatility changes) from each respective clearing member FCM. Each FCM in turn requires initial and variation margin (generally in an amount in excess of that demanded by the clearinghouse, although this can be a highly negotiated point, as discussed herein) from its client.

(b) Trade Execution Requirements

(i) Swap Execution Facilities

Title VII added Section 2(h)(8) of the CEA, which mandates that a swap that is cleared on a DCO be traded on a board of trade designated as a "contract market" ("DCM") (*i.e.*, historically, a futures exchange, which now may list swaps for trading or processing) or SEF except where (i) no DCM or SEF makes a swap "available to trade" or (ii) the swap transaction is subject to the clearing exemption under Section 2(h)(7) of the CEA. The determination as to whether a cleared swap has been "made available to trade" is issued by the CFTC ("MAT determination").

Title VII also amended the CEA to require the designation, registration, and regulation of SEFs (which are defined in the CEA as trading systems or platforms "in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants" in the systems or platforms).[22] Prior to the effectiveness of Title VII, many market participants utilized electronic trading systems and platforms to execute swaps and many such platforms fall within the CEA's definition of a SEF. As a result, these systems and platforms are subject to registration and regulation as SEFs. However, given the time involved in implementing the SEF-related provisions of the CEA, the CFTC permitted these platforms to continue to operate on an unregulated basis after the general effective date of Title VII until the CFTC adopted final rules governing their operations.[23]

On June 4, 2013, the CFTC adopted final rules regarding core principles and certain other requirements that apply to registered SEFs ("SEF Final Rules"), which became effective August 5, 2013.[24] The SEF Final Rules require SEFs to register with the CFTC and to comply with CFTC regulations beginning October 2, 2013 (although the compliance date for SEF core principals was delayed until November 1, 2013).[25] As a result, many trading systems and platforms that operated in an unregulated capacity pursuant to the SEF Order (and the amendments thereto) and the CFTC no-action letters extending the SEF compliance dates[26] are now required to operate as registered and regulated SEFs.

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22 CEA Sections 1a(50) and 5h. CEA Section 5h establishes a registration requirement for SEFs and sets forth certain "core principles" with which SEFs are required to comply. CEA Section 2(h)(8) requires that trades in a swap subject to a mandatory clearing requirement be executed on a DCM or a SEF.

23 *Effective Date for Swap Regulation*, 76 Fed. Reg. 42508 (Jul. 19, 2011)("SEF Order"); *Amendment to July 14, 2011 Order for Swap Regulation*, 76 Fed. Reg. 80233 (Dec. 23, 2011); Second Amendment to July 14, 2011 Order for Swap Regulation, 77 Fed. Reg. 41260 (Jul. 13, 2012).

24 *Core Principles and Other Requirements for Swap Execution Facilities*, 78 Fed. Reg. 33476 (Jun. 4, 2013). DCMs were already regulated prior to the adoption of Dodd-Frank and are subject to a different (but somewhat overlapping) set of core principals under Section 5(d) of the CEA.

25 *Time-Limited No-Action Relief for Temporarily Registered Swap Execution Facilities from Enforcement Responsibilities Under Commission Regulations 37.200(a), 37.200(b), 37.201(b)(1), 37.201(b)(3), 37.201(b)(5), 37.202(b) and 37.203*, CFTC No-Action Letter No. 13-57 (Sept. 27, 2013).

26 *Preservation of the Regulatory Status Quo Established with Respect to Certain Transactions by the Commission's Second Amendment to July 14, 2011 Order for Swap Regulation*, CFTC No-Action Letter 12-48 (Dec. 11, 2012); *Extension of the Regulatory Status Quo Established with Respect to Certain Transactions by the Commission's Second Amendment to the July 14, 2011 Order for Swap Regulation*, CFTC No-Action Letter No. 13-28 (Jun. 17, 2013).

(ii) Made Available to Trade Determinations

On June 4, 2013, the CFTC published Regulations 37.10 (SEFs) and 38.12 (DCMs) to establish a process through which registered SEFs and DCMs could submit their determinations to the CFTC for approval that a swap is available to trade for the purposes of the trade execution requirement.[27]

Under these rules, DCMs or SEFs must consider a series of factors in determining whether a swap is made available to trade, including:

- whether there are ready and willing buyers and sellers;
- the frequency or size of transactions on DCMs or SEFs, or of bilateral transactions;
- the trading volume on DCMs or SEFs, or of bilateral transactions;
- the number and type of market participants;
- the bid/ask spread; and
- the usual number of resting firm or indicative bids and offers.[28]

A DCM or SEF may only submit its determination to initiate the CFTC's MAT determination process for a swap (i) that lists for trading and (ii) that is subject to mandatory clearing.[29] Once the DCM or SEF makes its initial determination, the DCM or SEF must then submit its determination to the CFTC for approval as described in CFTC Regulation 40.5 or self-certification as described in CFTC Regulation 40.6. During the CFTC's review process, market participants may provide comments to the CFTC regarding the MAT determination.

Once the CFTC approves a transaction as made available to trade or the transaction is deemed certified as available to trade, then all other DCMs and SEFs that list or offer that swap for trading must do so in accordance with the trade execution requirements.

In addition, the CFTC may issue a determination that a swap is no longer available to trade upon determining that no DCM or SEF lists such swap for trading.

Under these rules, SEFs and DCMs could submit initial determinations on August 5, 2013, and the first determination was submitted on October 19, 2013 under CFTC Regulation 40.6(a) and is

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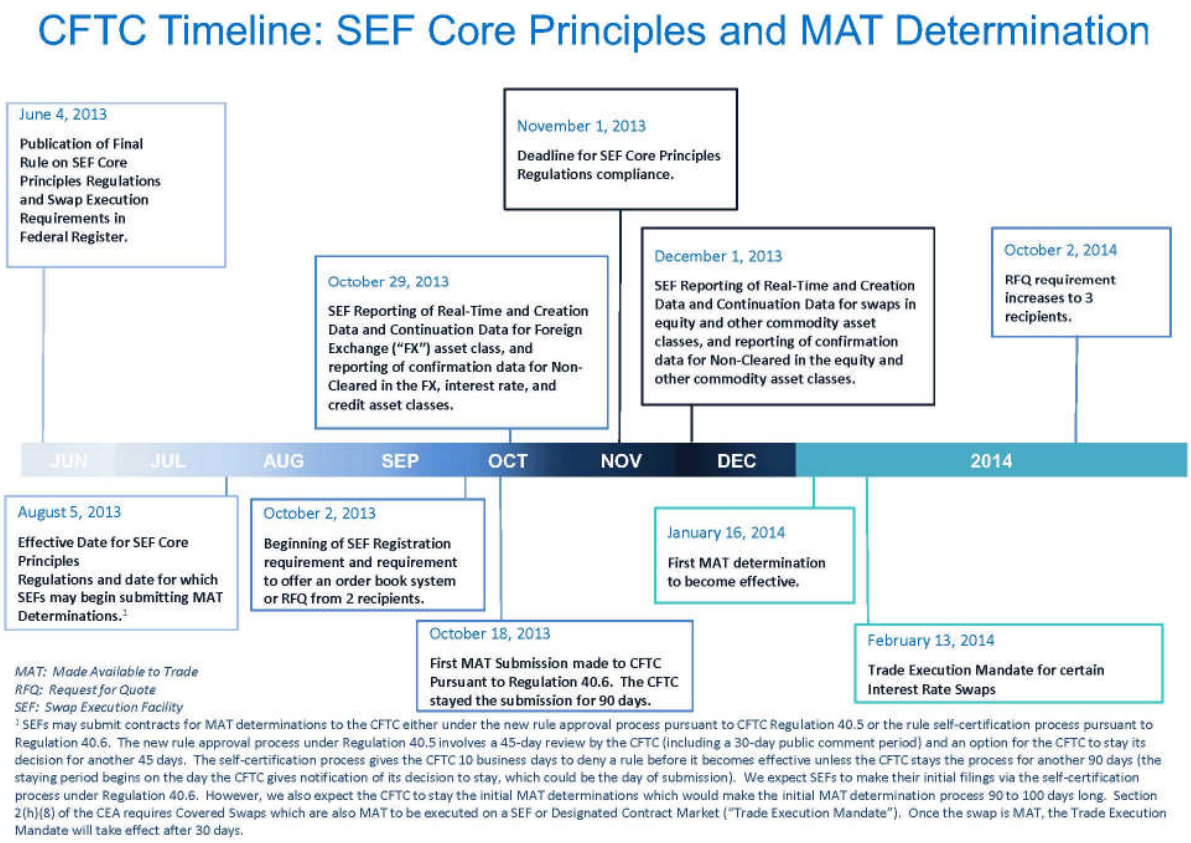
[27] *Process for a Designated Contract Market or Swap Execution Facility to Make a Swap Available to Trade, Swap Transaction Compliance and Implementation Schedule, and Trade Execution Requirement Under the Commodity Exchange Act*, 78 Fed. Reg. 33606 (Jun. 4, 2013).

[28] CFTC Regulations 37.10 and 38.12.

[29] CFTC Regulations 37.10(a)(2) and 38.12(a)(2). As noted herein, to date only certain CDS and IRS are subject to the mandatory clearing requirement pursuant to CFTC Regulation 50.4.

currently subject to a 90 day review period.[30] The following chart depicts the CFTC's timeline for implementing its initial MAT determination and the SEF Final Rules.



(iii) SEF Membership, Rulebook, and User Agreement Issues

Under the CEA and CFTC Regulations, a SEF is required to implement rules governing its operations, including rules relating to trading procedures for orders executed on the SEF.[31] SEFs are also required to establish rules and criteria governing market participants who utilize a SEF's services that are designed to deter market abuses. In addition to adopting rules, one of the core principles set forth in CEA Section 5h requires a SEF to enforce compliance with its rules.[32]

In order to comply with these requirements, each SEF has adopted its own rulebook governing the activities of its participants and has adopted its own user agreement to be executed by market

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30 *Javelin Determination of Made Available to Trade of Certain Interest Rate Swaps made Pursuant to Parts 37 of the Rules of the Commodity Futures Trading Commission*, Submission No. 13-06 (Oct. 18, 2013).

31 CEA Section 5h(f)(2)(C); CFTC Regulations 37.200 and 37.201.

32 CFTC Regulation 37.201(b) provides that a SEF must establish and impartially enforce compliance with its rules, including but not limited to: (i) the terms and conditions of any swaps traded or processed on or through the SEF; (ii) access to the SEF; (iii) trade practice rules; (iv) audit trail requirements; (v) disciplinary rules; and (vi) mandatory trading requirements.

participants in order to permit participants to trade (or continue to trade) on its platform. By executing a user agreement, a market participant agrees to adhere to the SEF's rulebook. Compliance with these requirements began November 1, 2013.[33]

Market participants should review SEF rulebooks and user agreements carefully and establish appropriate procedures to ensure compliance with applicable SEF rules. While the particulars of each rulebook and user agreement vary by SEF, as a general matter a rulebook requires participants to adopt appropriate procedures to ensure compliance with the SEF's rules and to supervise the participant's traders who utilize the platform. These documents also generally, among other things: (i) limit the liability of a SEF arising from a participant's use of the SEF; (ii) impose criteria that participants and their traders must satisfy in order to utilize a SEF; (iii) grant a SEF the authority to revoke a participant's access to the SEF; (iv) authorize a SEF to impose fines and take other disciplinary actions against a participant in certain instances; and (v) require a participant to consent to a SEF's jurisdiction. Market participants will generally be required to have agreed to the rules of a SEF prior to utilizing that SEF to execute swap transactions.

The following are examples of rulebook requirements and provisions that funds should consider before agreeing to the rules of a SEF:

- broad limitations on the liability of a SEF and its contractors arising from a participant's use of the SEF, in some cases regardless of the fault of the SEF or its contractor;
- imposition of criteria that participants and their traders must satisfy in order to utilize a SEF, which are often broad and vaguely worded (*e.g.*, the participant must be "of good reputation and business integrity" and "maintain adequate financial resources and credit," and authorized traders must be "technically proficient");
- grant to the SEF the authority to revoke a participant's or authorized trader's access to the SEF for any reason and without prior notice in some instances;
- grant to the SEF the authority to suspend a participant's trading privileges if a clearing member rejects a swap;
- authorization of the SEF to impose fines and take other disciplinary actions against a participant in certain instances, sometimes without any procedure to appeal;
- fines of $1,000,000 or higher;
- requirements that the participant consent to a SEF's jurisdiction;
- requirements that the participant disclose certain information or the occurrence of certain events to the SEF immediately;

[33] *Time-Limited No-Action Relief for Temporarily Registered Swap Execution Facilities from Enforcement Responsibilities Under Commission Regulations 37.200(a), 37.200(b), 37.201(b)(1), 37.201(b)(3), 37.201(b)(5), 37.202(b) and 37.203*, CFTC No-Action Letter No. 13-57 (Sept. 27, 2013).

- requirements that the participant has reasonable procedures to ensure that authorized traders comply with applicable laws and the SEF rulebook; and

- "enablement mechanisms," which prevent a market participant from interacting or trading with, or viewing the bids and offers displayed by, other market participants on a SEF. Note that the CFTC has recently issued guidance that such restrictions are in violation of CFTC Regulation 37.202.[34]

(iv) Other Requirements Applicable to SEF Members

In addition to the requirements imposed by SEF user agreements and rulebooks, market participants should also note additional CFTC regulations applicable to SEF members, such as recordkeeping rules in CFTC Regulations 1.35 and 1.31.

(c) Swap Data Reporting Requirements

(i) SDR Reporting: Swap Initiation and Continuation Data

Dodd-Frank amended the CEA to impose new reporting requirements for swap transactions. CEA Section 2(a)(13)(G) requires reporting of all swap transactions to a new class of registered entities, swap data repositories ("SDRs"). CEA Section 21(b) directs the CFTC to determine what data elements must be reported as well as standards for the collection and maintenance of such data. CEA Section 4r specifically addresses uncleared swaps, assigning reporting responsibilities to various swap counterparties to ensure that at least one counterparty to each swap transaction reports the transaction. In CEA Section 2(a)(13)(E), Dodd-Frank addresses the dissemination of this information to the public by directing the CFTC to prescribe rules for cleared swaps that ensure that the identities of swap participants are not disclosed to the public, and that appropriate delays are used in the reporting of large notional swap transactions, and to consider any impact of swap reporting on market liquidity. CEA Section 2(a)(13)(B) gives the CFTC general discretion to determine the form and timing of all public reporting of swap data.

Under the CFTC's swap transaction data reporting rules that implement these CEA sections, two main categories of data must be reported to an SDR: (i) swap creation data, which consists the swap's primary economic terms ("PET") and confirmation data; and (ii) swap continuation data, which consists of valuation and life cycle event data.[35]

On November 20, 2013, the CFTC made certain data publicly available when it issued the first Weekly Swaps Report ("Report").[36] The Report includes the gross notional outstanding value, the weekly transactions measured by dollar volume, and the weekly transactions measured by ticket volume for IRS and CDS. The Report further provides detailed breakdowns of the swap markets

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[34] CFTC, *Guidance on Application of Certain Commission Regulations to Swap Execution Facilities* (Nov. 14, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf.

[35] CFTC Regulations 45.1, 45.3, and 45.4.

[36] *CFTC Announces Weekly Swaps Report*, Release: PR6780-13 (Nov. 20, 2013), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6780-13. The Report is available at http://www.cftc.gov/MarketReports/SwapsReports.

by product type, currency, tenor, participant type, and cleared or uncleared swaps for each asset class. The Report showed that, as of November 8, 2013, the outstanding notional amount totals were $320 trillion for IRS (61% of which were cleared) and $9.1 trillion for CDS (23% of which were cleared).[37]

(ii) Duty to Report

Non-swap dealer and non-major swap participants counterparties ("Non-SD/MSPs") will only bear reporting responsibilities if the other counterparty is a Non-SD/MSP, and only under one of three circumstances:

- If the swap *is* executed on or pursuant to the rules of a SEF or DCM and the swap is *not* cleared by a DCO, then the Non-SD/MSP will have to provide continuation data for the life of the swap (but will not need to provide creation data, which is reported by the SEF or DCM).

- If the swap is *not* executed on or pursuant to the rules of a SEF or DCM and the swap *is* accepted for clearing by a DCO *after* the applicable deadline for reporting PET data has passed, then the Non-SD/MSP must report the PET data (but does not need to provide confirmation data or any continuation data, both of which are provided by the DCO).

- If the swap is *not* executed on or pursuant to the rules of a SEF or DCM and the swap is *not* cleared, then the Non-SD/MSP must assume all reporting obligations for both creation data and continuation data.[38]

(d) Proposed Margin Requirements for Uncleared Swaps

Dodd-Frank requires the adoption by the CFTC and SEC as well as the U.S. Federal Reserve Bank, the U.S. Office of the Comptroller of Currency, the U.S. Federal Deposit Insurance Corporation, the U.S. Farm Credit Administration, and the U.S. Federal Housing Finance Authority (collectively "prudential regulators") of margin requirements for uncleared derivatives.[39] These requirements have not yet been adopted as final by any regulator. Currently, there are three outstanding regulatory frameworks from (i) the CFTC, (ii) the SEC, and (iii) the prudential regulators. The Basel Committee on Banking Supervision and the International Organization of Securities Commissions ("BCBS/IOSCO") have also released a policy framework intended to establish minimum requirements to guide various regulators in establishing margin rules.

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37 *Id.*

38 CFTC Regulations 45.3, 45.4, and 45.8. *See also Swap Data Recordkeeping and Reporting Requirements*, 77 Fed. Reg. 2136, 2156-57 (Jan. 13, 2012) (codified at 17 C.F.R. pt. 45) (providing diagram illustrating allocation of reporting responsibilities).

39 Dodd-Frank Section 764.

(i) CFTC Margin Proposal

The CFTC's proposed margin rules would apply to, and require margin collection by, all swap dealers and major swap participants that are not prudentially regulated.[40] The proposed rules contemplate different requirements depending on the category of the counterparty, as follows:

- Swap dealers and major swap participants are proposed to be required to collect and pay initial and variation margin for transactions with other swap dealers or major swap participants.

- Swap dealers and major swap participants are proposed to be required to collect initial and variation margin from a counterparty that is a Non-SD/MSP and is a financial entity, but are not proposed to be required to pay margin to such a counterparty.

- Commercial end-users—defined as non-financial entities under the proposed margin rules—would not be subject to margin requirements but would be required to enter into credit support arrangements with the counterparty, and the swap dealer/major swap participant would be required to calculate hypothetical initial and variable margin amounts to serve as risk management tools to measure exposure.

The proposal would only apply to uncleared swaps entered into after the effective date of the final rule.

Any type of collateral could be used as margin by non-financial entities, subject to the credit support agreement, as long as the value of the collateral could be reasonably ascertained. In transactions between a swap dealer or major swap participant and another swap dealer or major swap participant or a Non-SD/MSP financial entity, only cash, U.S. obligations, or certain senior debt obligations of government entities could be used for initial margin, and only cash or U.S. Treasury securities could be used for variation margin.

For transactions between a swap dealer or major swap participant and another swap dealer or major swap participant, initial margin must be held by a custodian. While not required for transactions between a swap dealer or major swap participant and a Non-SD/MSP, the swap dealer/major swap participant must permit the Non-SD/MSP to elect to have initial margin held by a custodian.

(ii) SEC Margin Proposal

The SEC's proposed margin rules would apply to security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs").[41] The proposal would require:

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40 *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23).

41 *Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers*, 77 Fed. Reg. 70214 (proposed Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240). SBSDs and MSBPs are generally the counterparts to swap dealers and major swap participants that trade SEC-regulated products.

- SBSDs to collect initial and variation margin from all OTC security-based swap counterparties (*i.e.*, unilateral coverage of current and potential future exposure) except for commercial end-users that are using the swaps for hedging, and

- MSBSPs to collect or post only variation margin (*i.e.*, bilateral coverage of current exposure) based on daily exposure calculations, except for exposure to commercial end-users and SBSDs.

The margin requirements would apply to any accounts that are holding uncleared security-based swaps and would be based on the total exposure to the account, including exposure due to instruments other than swaps. The requirements would only apply to security-based swaps entered after the effective date of the final rule.

The SEC proposal would limit permitted collateral to cash, securities, or money market instruments, as long as the securities or money market instruments had a ready market and could be offered and sold to the public. The SBSD or MSBSP would be required to allow the counterparty to elect to have the collateral held by a custodian. However, if the counterparty elects to have collateral held by a custodian, such collateral would no longer meet the proposal's collateral requirements—*i.e.*, that an SBSD or MSBSP must have physical possession or control over a counterparty's collateral and must be able to promptly liquidate collateral. Under the proposal, collateral not meeting those requirements cannot be included when the SBSD or MSBSP calculates the equity in a counterparty's account, which means that the SBSD or MSBSP would be required to take a capital charge in an amount equal to the amount of margin that the SBSD or MSBSP is required to collect from the counterparty.

(iii) Prudential Regulator Margin Proposal

Dodd-Frank requires a swap dealer, major swap participant, SBSD, or MSBSP that, in lieu of being regulated by the CFTC or SEC is regulated by a prudential regulator, to meet margin requirements set by such prudential regulator. If there is no prudential regulator, Dodd-Frank requires such entities to meet CFTC and SEC margin requirements. The prudential regulator proposal would require unilateral margin collection by all swap dealers, major swap participants, SBSDs, and MSBSPs, and it would require all OTC swap counterparties to post margin.[42] Non-SD/MSP/SBSD/MSBSP counterparties are further divided into three categories: high-risk financial end-users, low-risk financial end-users, and non-financial end-users. These classifications affect whether initial margin thresholds may be used and the amounts of those thresholds. The proposal would apply both to swaps and security-based swaps entered into 180 days after the publication of the rules.

Under the proposal, only the following could be used as collateral: cash, U.S. obligations, or debt obligations of certain government entities. For transactions between a swap dealer/major swap participant/SBSD/MSBSP and another swap dealer/major swap participant/SBSD/MSBSP, initial margin must be held by a custodian. The proposal does not include custodial requirements for transactions involving other counterparties.

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[42] *Margin and Capital Requirements for Covered Swap Entities*, 76 Fed. Reg. 27564 (proposed May 11, 2011) (to be codified at 12 C.F.R. pt. 45, 237, 324, 624, 1221).

(iv) BCBS/IOSCO Margin Policy Framework

In response to a directive from the Group of Twenty ("G20") in 2011 to develop margin requirements for non-cleared derivatives, BCBS/IOSCO released a final policy framework intended to establish minimum requirements to guide regulators in G20 nations in the adoption of margin rules for non-cleared derivatives.[43]

This framework applies beyond swaps and security-based swaps to cover all non-cleared derivative transactions. All participants would be required to collect and post initial and variation margin, with exceptions for transactions involving non-financial entities that are not "systemically important," sovereigns, central banks, multilateral development banks, and the Bank for International Settlements. Regulators in each country are charged with defining which entities are "systemically important." The framework provides for a phase-in of margin requirements, beginning in December 2015. Initially, only variation margin must be exchanged, with the requirement to exchange initial margin phased in from 2015 to 2019, based on the size of the participant as measured by the notional amount of non-cleared derivatives. The requirements only apply to new contracts entered into after the phase-in date of the applicable requirement.

The framework does not enumerate specific types of permissible collateral but rather requires national regulators to develop lists of acceptable collateral, which must be highly liquid and have the potential to withstand periods of financial uncertainty that may accompany the failure of a derivative counterparty. The framework requires margin to be held in a manner that protects the posting party in the event the collecting party enters bankruptcy but permits rehypothecation under certain circumstances and subject to a series of protective limitations.

(e) Trading Documentation

(i) Clearing Agreements and Related Documentation

FCMs generally document clearing relationships with their clients using a futures and options account agreement and a "cleared derivatives addendum" published by the Futures Industry Association ("FIA") and ISDA ("Cleared Derivatives Addendum"). The Cleared Derivatives Addendum is a template for FCMs and their customers to document their cleared OTC swaps and is usually customized in some fashion by each FCM. It includes representations for each party to make regarding certain clearing-related matters (such as the treatment of customer collateral), and also sets forth the close-out methodology for cleared OTC swaps, the triggers for liquidation, and provisions for valuing the terminated trades (among other provisions). It also governs tax issues regarding cleared OTC transactions.

Fund groups generally negotiate the terms of the Cleared Derivatives Addendum to protect against FCM credit risk and add a number of substantive terms, including, among other things:

- Limits on margin charged by the FCM to match the rates charged by the applicable clearinghouse.

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[43] Basel Committee on Banking Supervision & International Organization of Securities Commissions, *Margin Requirements for Non-Centrally-Cleared Derivatives* (Sept. 2, 2013), *available at* http://bis.org/publ/bcbs261.pdf.

- Required notice periods prior to imposition of additional margin cushion requirements by FCM.

- Morning margin call deadlines for same-day margin delivery; a grace period of one day for delivery of margin; and requirements for daily return of excess margin in accordance with SEC guidance in Rule 17f-6 under the U.S. Investment Company Act of 1940 as amended.[44]

- Limits on the FCM's ability to (i) impose new position limits that are more restrictive than those of the CFTC and clearinghouse, or (ii) reduce FCM existing swap position limits without prior notice.

- Required notice period prior to FCM close-out of open positions absent an event of default.

- FCM commitment to clear new orders and accept transactions ported from another FCM if the orders or transactions are "conforming swap transactions" that fall within agreed-upon portfolio limitations.

- Hard deadline for porting swap transactions away from the FCM.[45]

- Limits on events of default with respect to the customer so that only "credit-bearing" events of default (*i.e.*, failure to pay margin and bankruptcy) can trigger termination of the relationship.

- Agreed-upon schedules for financing charges/credits and settlement fees.

- Requirement that the FCM pay interest on credit balances in the customer account.

- Right of set-off against amounts owed by FCM upon FCM insolvency.[46]

(ii) ISDA Framework and Protocols

ISDA has published a number of protocols that serve to amend outstanding ISDA Master Agreements (and related documentation) to incorporate certain information required under Dodd-Frank and associated CFTC rulemakings ("ISDA Dodd-Frank Protocols"). The ISDA Dodd-Frank Protocols are contractual agreements between counterparties and do not impose any regulatory obligations on an adherent. Certain regulatory requirements may apply regardless of whether a participant has adhered to any ISDA Dodd-Frank Protocols, depending on the participant's trading

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44 SEC Reg. 17f-6(a)(2).

45 Although Rule 2-27 of the U.S. National Futures Association requires porting within three business days, there is the view that employees of an insolvent FCM may be more likely to provide porting in a timely manner if there is a contractual obligation to do so.

46 Although an FCM is an agent of its customers and cleared swap customer collateral is subject to certain customer protections (discussed herein), cleared swap customers still face the risk of FCM bankruptcy with concurrent shortfalls in segregated customer funds due to operational risks (*e.g.*, negligence, theft, or other mishap).

activities. The ISDA Dodd-Frank Protocols attempt to streamline the regulatory compliance process for dealers and their counterparties.

There are currently two ISDA Dodd-Frank Protocols: the ISDA August 2012 Dodd-Frank Protocol ("Protocol 1.0"); and the ISDA March 2013 Dodd-Frank Protocol ("Protocol 2.0"). The key distinction is that Protocol 1.0 is designed to help adherents comply with the CFTC's external business conduct standards ("Business Conduct Rules") (also known as the Category B Transaction-Level Requirements),[47] while Protocol 2.0 is aimed to facilitate compliance with certain Category A Transaction-Level Requirements, described in greater detail herein.[48] Counterparties may adhere to either or both protocols. ISDA has also published certain other forms relating to Dodd-Frank, including a form account control agreement and a cross-border swaps representation letter.

A. Protocol 1.0

To help ensure the dealer's compliance with the Business Conduct Rules, Protocol 1.0 facilitates the delivery of extensive "know your customer" information from the counterparty to the dealer.[49] Additional disclosure is required for ERISA or other "Special Entities" as defined in the CFTC regulations.[50]

Protocol 1.0 also requires the counterparty to make a number of representations and covenants. Among these are the following obligations:

- To promptly notify the dealer of any material change in information.[51]
- To promptly provide the dealer with "any information reasonably requested" to enable the dealer to comply with Dodd-Frank and related CFTC regulations.[52]
- To report certain "life cycle events" on the second business day following the day on which they occur.[53]
- To have adequate policies and procedures in place to ensure that the person (whether the adherent itself or a third-party service provider) evaluating swap recommendations and making trading decisions on behalf of the adherent is capable of doing so.[54]

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47 CEA Section 4s(h); CFTC Regulations Part 23, Subpart H.

48 CEA Sections 2(h);4s(i) and CFTC Regulations Part 23, Subpart I and Part 50.

49 ISDA August 2012 DF Supplement Schedule 2.

50 CEA Section 4s(h)(2)(C); CFTC Regulation 23.401(c).

51 ISDA August 2012 DF Supplement Section 2.3.

52 ISDA August 2012 DF Supplement Section 2.4.

53 ISDA August 2012 DF Supplement Section 2.10.

54 ISDA August 2012 DF Supplement Sections 3.1(a), 3.2(a), 4.1(c), 4.3(a), and 5.1(b)(1).

B. Protocol 2.0

Protocol 2.0 facilitates compliance with the following Category A Transaction-Level Requirements:

- *Portfolio Reconciliation*: Provides a framework for meeting the portfolio reconciliation and dispute resolution requirements in Dodd-Frank.[55] There are two reconciliation methods. Counterparties can choose either "Review" of Portfolio Data or "Exchange" of Portfolio Data. Portfolio reconciliation under Dodd-Frank is required either annually or quarterly, based on whether the counterparty surpasses a threshold of 100 trades per quarter.[56]

- *Swap Trading Relationship Documentation*: Dealers must have documentation in place documenting the terms that govern the trading relationship with counterparties.[57]

- *Valuation and Dispute Resolution*: Protocol 2.0 specifically covers valuation and dispute resolution, while other terms will typically be found in swap confirmations.[58]

- *End-User Exception*: Dodd-Frank provides an exception from mandatory clearing if a customer qualifies as an "end-user."[59] Protocol 2.0 contains a number of representations for dealers to obtain the information needed to ensure regulatory compliance in lieu of clearing with these counterparties.[60] This generally does not apply to funds.

C. ISDA 2013 Account Control Agreement

On October 11, 2013, ISDA published the ISDA 2013 Account Control Agreement ("ISDA ACA"), which is designed to create a standardized tri-party control agreement to provide for segregation of collateral with a third-party custodian.[61] Similar to the ISDA Master Agreement and Credit Support Annex, the ISDA ACA consists of a standard agreement with an accompanying annex that allows parties to negotiate specific provisions and make certain elections.

D. ISDA Cross-Border Swaps Representation Letter

On August 19, 2013, ISDA published its "Cross-Border Swaps Representation Letter."[62] This letter is designed to allow swap counterparties to make representations to their swap dealers to assist swap dealers with determining whether the CFTC will assert jurisdiction over the swap

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55 ISDA March 2013 DF Supplement Schedule 4.

56 CFTC Regulation 23.502(b)(3).

57 ISDA March 2013 DF Supplement Section 2.4.

58 ISDA March 2013 DF Supplement Schedule 3.

59 CFTC Regulation 50.50.

60 ISDA March 2013 DF Supplement Sections 2.9-2.11.

61 The ISDA ACA can be downloaded from the ISDA website at http://www2.isda.org/functional-areas/infrastructure-management/collateral/.

62 The Cross-Border Swaps Representation Letter can be downloaded from the ISDA website at http://www2.isda.org/dodd-frank-documentation-initiative/.

pursuant to the CFTC's guidance and related U.S. person definition, published on July 26, 2013 (discussed herein). The letter requires the counterparty to represent whether it reasonably believes that it is a "U.S. person" (as defined by the CFTC). If the counterparty represents that it is not a U.S. person, it must further represent whether it is an "affiliate conduit" (as defined by the CFTC) or has a guarantee from a U.S. person, which may also subject the swap to CFTC jurisdiction.

IV. CROSS-BORDER GUIDANCE AND U.S. PERSON DEFINITIONS

(a) CFTC Cross-Border Guidance and U.S. Person Definition

Title VII added Section 2(i) of the CEA, which provides that the CEA swap provisions generally do not apply to swap activities outside of the United States unless such activities (i) have a direct and significant connection with activities in, or effect on, commerce of the United States, or (ii) contravene CFTC rules preventing the evasion of the CEA swap provisions.

In July 2013, the CFTC approved and issued its final interpretive guidance and policy statement on the cross-border application of the swap regulation provisions of the CEA and related CFTC regulations ("Guidance").[63] Among other things, the Guidance provides the CFTC's definition of the term "U.S. person" with respect to the application of the CEA swap provisions and the CFTC swap regulations promulgated under Dodd-Frank. This U.S. person definition will be used by swap dealers and major swap participants in determining the U.S. requirements applicable to swap transactions and relationships with such persons.[64]

(i) CFTC U.S. Person Definition

The CFTC's U.S. person definition generally encompasses (i) persons located in the United States, and (ii) persons domiciled or operated outside of the United States but whose swap activities satisfy the CEA jurisdictional nexus. The U.S. person definition specifically includes:

(i) any natural person who is a resident of the United States;

(ii) any estate of a decedent who was a resident of the United States at the time of death;

(iii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing (other than an entity described in prong (iv) or (v) below) ("legal entity"), in each case that is organized or incorporated under the laws of a state or

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63 *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, 78 Fed. Reg. 45292 (Jul. 26, 2013)("Guidance"). The CFTC also adopted an exemptive order providing temporary conditional relief from compliance with certain provisions of the Guidance for certain entities subject to the CFTC's definition of U.S. person ("Exemptive Order"), which delayed compliance with certain parts of the Guidance. *Exemptive Order Regarding Compliance with Certain Swap Regulations*, 78 Fed. Reg. 43785 (Jul. 22, 2013).

64 The CFTC does not intend for the Guidance to address how a person's or entity's U.S. person status should be interpreted in connection with any other CEA provisions or CFTC regulations, including CFTC jurisdiction over commodity pool operators ("CPOs") and commodity trading advisors ("CTAs").

other jurisdiction in the United States or having its principal place of business in the United States;

(iv) any pension plan for the employees, officers, or principals of a legal entity described in prong (iii) above, unless the pension plan is primarily for foreign employees of such entity;

(v) any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) any commodity pool, pooled account, investment fund, or other collective investment vehicle that is not a legal entity described in prong (iii) above and that is majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) above, except any commodity pool, pooled account, investment fund, or other collective investment vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons;

(vii) any legal entity (other than a limited liability company, limited liability partnership, or similar entity where all of the owners of the entity have limited liability) that is directly or indirectly majority-owned by one or more persons described in prong (i), (ii), (iii), (iv), or (v) above and in which such persons bear unlimited responsibility for the obligations and liabilities of the legal entity; and

(viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in prong (i), (ii), (iii), (iv), (v), (vi), or (vii) above.

The CFTC stated that the definition of U.S. person generally includes the foregoing persons but is "not limited to" such persons. The CFTC noted that there may be situations in which a person not specified within the enumerated definitions is appropriately treated as a U.S. person "in view of the relevant facts and circumstances and a balancing of the various regulatory interests that may apply."

(ii) Transactions with Non-U.S. Person Swap Dealers

The Guidance provides that Transaction-Level Requirements do not apply to transactions between a non-U.S. person swap dealer/major swap participant and another non-U.S. person. However, the staff of the CFTC's Division of Swap Dealer and Intermediary Oversight has issued an advisory providing that a non-U.S. swap dealer (whether an affiliate or not of a U.S. person) regularly using personnel or agents located in the United States to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements.[65] The compliance date will be January 14, 2014.[66]

(iii) CFTC Substituted Compliance Regime

The Guidance provides that non-U.S. persons transacting with non-U.S. "branches" of U.S. swap dealers may comply with the regulatory regimes of the non-U.S. jurisdiction in which they operate instead of the CFTC regulations (subject still to CFTC examination and enforcement authority) if the CFTC makes a determination that the foreign jurisdiction's requirements "are comparable with and as comprehensive as the corollary area(s) [under the CFTC's] Entity- and Transaction-Level Requirements."[67] A collective investment vehicle that is a non-U.S. person transacting with a non-U.S. branch of a U.S. person swap dealer would benefit from this substituted compliance regime.

In addition, the Exemptive Order provided a temporary delay for non-U.S. branches of U.S. swap dealers in six specified jurisdictions from complying with the CFTC's Transaction-Level Requirements in anticipation of the CFTC making a "substituted compliance" determination with respect to those jurisdictions (which has yet to occur).[68] Instead, the non-U.S. branch of a U.S. swap dealer may comply with applicable foreign law in lieu of complying with the CFTC's Transaction-Level Requirements until the earlier of (i) December 21, 2013 or (ii) 30 days after the CFTC makes a substituted compliance determination.[69] However, this does not apply to compliance with the mandatory clearing requirements for applicable swaps (as noted above, currently only certain CDS and IRS), effective for all swap participants starting on October 9, 2013.

(iv) EMIR No-Action Relief

Additionally, on July 11, 2013, the CFTC issued no-action relief to swap dealers and major swap participants organized in the United States or European Union ("EU") from certain documentation, portfolio reconciliation, and other regulatory requirements under Dodd-Frank when subject to existing EU risk mitigation regulations that are "essentially identical" to CFTC regulations.[70] This no-action relief applies solely to (i) uncleared swaps and (ii) physically-settled foreign exchange

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65 CFTC Staff Advisory No. 13-69 (pub. avail. Nov. 14, 2013).

66 CFTC No-Action Letter No. 13-71 (Nov. 26, 2013).

67 Guidance, at 45342.

68 Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland. *Exemptive Order*, at 43788. At this time, certain other significant financial services jurisdictions are not included, such as Singapore, South Korea, and Taiwan (among others).

69 *Exemptive Order*, at 43789.

70 CFTC No-Action Letter No. 13-45 (Jul. 11, 2013).

forward and swap agreements exempted from the definition of swap by the U.S. Department of the Treasury.[71]

(v) Guidance Regarding Collective Investment Vehicles

The Guidance specifically considers the "principal place of business" of collective investment vehicles for determining U.S. person status. The CFTC clarified that the primary focus for identifying the principal place of business with respect to such vehicles will be the location of the investment managers, fund sponsors and promoters, and sales and trading desks used by an investment manager, or the "actual center of direction, control and coordination."[72] The CFTC will focus primarily on where senior personnel are located.[73] The CFTC will consider a vehicle's principal place of business to be in the United States if its senior principal personnel responsible for either (i) the "formation and promotion" of the vehicle or (ii) the "implementation of the vehicle's investment strategy" are in the United States.[74]

In conducting this inquiry, the CFTC will not look to the location of a vehicle's board of directors or trustees, because boards (while having the legal authority to manage the overall business of the vehicle and specifically to hire and fire the investment managers) do not have the function of actually implementing the investment objectives of funds and so would not be viewed as "key personnel."[75] Additionally, the locations of the vehicle's board meetings, registered office, or books and records are generally not relevant to the vehicle's U.S. person status.

The CFTC specifically stated that it would not consider a collective investment vehicle to be a U.S. person where some investment personnel or an independent, hired sub-adviser's personnel are located in the United States, so long as such persons report to non-U.S. persons who are considered to be fulfilling the "key functions relating to [the vehicle's] formation or the achievement of its investment objectives."[76] This should put to rest the concern that a non-U.S. vehicle would be considered a U.S. person solely because it employs a U.S. CTA that functions under the direction of senior personnel located outside of the United States.

The Guidance also provides that a collective investment vehicle organized outside the United States will not be a U.S. person if it is publicly offered solely to non-U.S. persons and is not offered to U.S. persons.

However, even if a collective investment vehicle is not a U.S. person under prong (iii) above, it may still be a U.S. person under prong (vi) if is it majority-owned by U.S. persons.

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71 *Id.* at 3.

72 Guidance, at 45309.

73 Guidance, at 45310.

74 *Id.*

75 *Id.*

76 Guidance, at 45311 n. 207.

(vi) Impact on Collective Investment Vehicles

The Guidance addresses the CFTC's extraterritorial jurisdictional issues for compliance with swap clearing, reporting, and other aspects of Dodd-Frank. It does not impact the analysis of whether a CPO or CTA may be subject to CFTC jurisdiction.

Under the Guidance, a collective investment vehicle that is deemed to be a U.S. person will be subject to Transaction-Level Requirements.

U.S. person CFTC-registered swap dealers and major swap participants, non-U.S. person CFTC-registered swap dealers and major swap participants, and certain other non-U.S. persons are subject to the CFTC's Entity-Level requirements.

A sub-set of the Entity-Level Requirements and Transaction-Level Requirements would apply to transactions between a U.S. person fund and a non-U.S. person non-registrant, including large trader reporting, SDR reporting, clearing, trade execution, real-time public reporting, and swap data recordkeeping requirements. Where a collective investment vehicle that is a U.S. person enters into a swap with a non-U.S. person, obligations that would generally fall to the swap dealer (*i.e.*, SDR reporting and recordkeeping) could instead become the responsibility of the U.S. person vehicle. SDR reporting particularly will be burdensome for vehicles since many non-U.S. swap dealers have not established reporting mechanisms or agreements and are subject to later dates for compliance with the swap dealer registration and compliance requirements (including reporting).

Where a collective investment vehicle is a non-U.S. person but is trading swaps with a swap dealer determined to be a U.S. person, the vehicle will be subject to the CFTC's Transaction-Level Requirements with regard to its swaps. However, the actual compliance obligations will fall to the U.S. person swap dealer.

(b) SEC Proposed Cross-Border Guidance and U.S. Person Definition

In May 2013, the SEC proposed its own rules and interpretive guidance to explain the application of the provisions of the Exchange Act that were added by Dodd-Frank to cross-border security-based swap activities ("Proposed SEC Guidance").[77] The Proposed SEC Guidance also sets forth when SBSDs, MSBSPs, and other entities such as clearing agencies, execution facilities, and data repositories must register with the SEC. Comments received from the public on the Proposed SEC Guidance are currently being considered by the SEC.

Under the Proposed SEC Guidance, the SEC would apply its security-based swap rules to security-based swap activities involving (i) a U.S. person or (ii) a transaction conducted within the United States. The SEC's proposed definition of "U.S. person" under proposed Rule 3a71-3 under the Exchange Act includes:

(i) any natural person resident in the United States;

[77] *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, 78 Fed. Reg. 30968 (proposed May 23, 2013).

(ii) any partnership, corporation, trust, or other legal person organized or incorporated under the laws of the United States or having its principal place of business in the United States; and

(iii) any account (whether discretionary or non-discretionary) of a U.S. person.

The definition of U.S. person expressly does not include the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, and their agencies and pension plans, and any other similar international organizations and their agencies and pension plans.

A "transaction conducted within the United States" is defined under proposed Rule 3a71-3 as a security-based swap transaction that is "solicited, negotiated, executed, or booked within the United States, by or on behalf of either counterparty to the transaction, regardless of the location, domicile, or residence status of either counterparty to the transaction."

The Proposed SEC Guidance also includes a process that the SEC proposes to use in considering substituted compliance requests, which this paper will not describe in detail because it has not yet been finalized.

(c) EMIR and Cross-Border Guidance

The EU also has adopted a regulation on derivatives, central counterparties, and trade repositories, titled the European Market Infrastructure Regulation ("EMIR"). In practice, all derivatives (whether transacted in or outside the EU) are within the scope of EMIR, other than (i) physically settled spot FX transactions, and (ii) physically settled commodity derivatives which are entered into for commercial purposes.

Under EMIR, the European Commission (on the advice of the European Securities and Markets Authority ("ESMA")) will determine that a third country's arrangements are "equivalent" to EMIR's requirements. This will allow the party to be deemed to comply with the EMIR clearing, reporting, and risk mitigation obligations by virtue of at least one counterparty complying with the equivalent arrangements in the third country. ESMA has conducted equivalence studies in the United States, Japan, Hong Kong, Switzerland, Canada, and Australia. With respect to certain significant U.S. requirements, the European Commission found as follows:

Clearing. The CFTC and the European Commission have essentially identical processes to designate mandatory clearing obligations. The same products are likely to be subject to clearing in the United States and the EU. In terms of which market participants are covered, regulators have agreed to a "stricter rule applies" approach where exemptions from clearing exist in one jurisdiction but not the other. As a result, where an entity is subject to both U.S. and EU rules on clearing, it may disapply the EU obligation if the product is subject to clearing in the United States and the EU.

Risk Mitigation. The CFTC and EMIR's risk mitigation provisions compare as follows:

(i) Timely confirmation – equivalent, but reporting of unconfirmed trades to the EU regulator is not disapplied.

(ii) Portfolio reconciliation – equivalent.

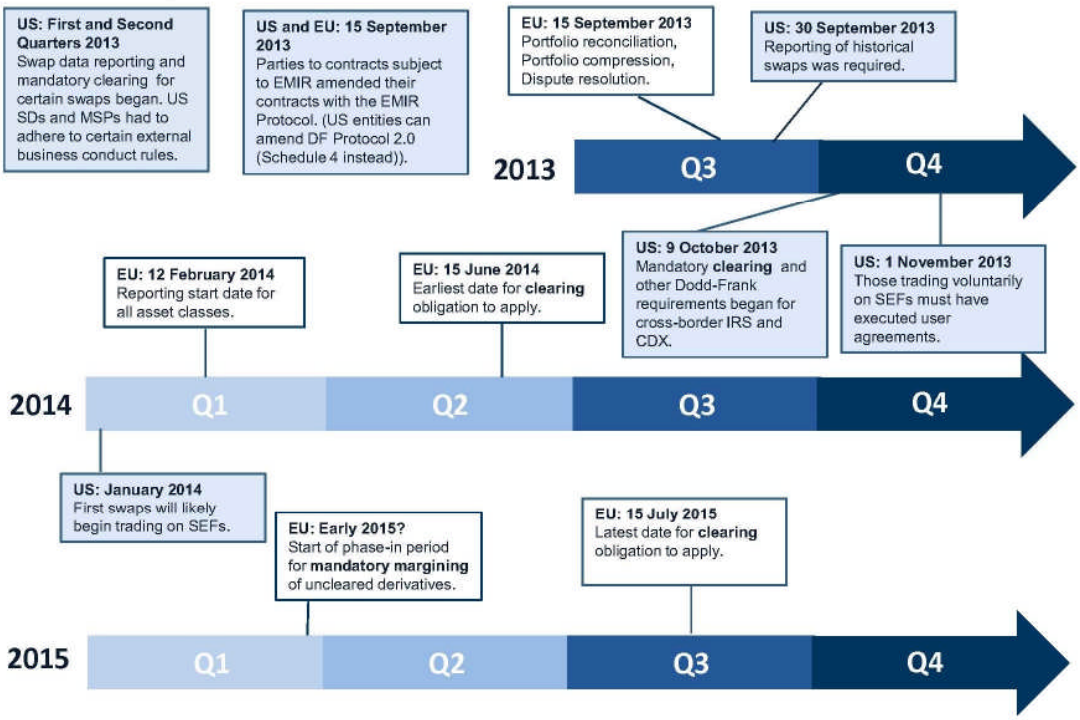
(iii) Portfolio compression – equivalent.

(iv) Dispute resolution – not equivalent.

(v) Bilateral margining – to be confirmed, once rules are in place.

(vi) Reporting – not equivalent. CFTC data fields do not encompass all of EMIR's data fields, such as exposure.

As a result of the above, U.S. person funds may be subject to both Dodd-Frank and EMIR requirements. The following chart sets forth the implementation deadlines for EMIR provisions.



To facilitate EMIR compliance, ISDA has published two protocols: the ISDA 2013 EMIR NFC Representation Protocol ("NFC Protocol"); and the ISDA 2013 EMIR Portfolio Reconciliation,

Dispute Resolution and Disclosure Protocol ("EMIR Protocol"). The NFC Protocol allows counterparties to amend existing ISDA Master Agreements to reflect certain EMIR "know your counterparty" requirements.[78] The EMIR Protocol allows parties to amend ISDA Master Agreements and other derivatives agreements to comply with the portfolio reconciliation and dispute resolution requirements imposed by EMIR. The EMIR Protocol also includes a disclosure waiver that is intended to assist compliance with EMIR reporting and recordkeeping requirements without breaching parties' existing confidentiality agreements.[79]

V. CUSTOMER PROTECTION RULES

(a) Segregation of Customer Funds

The CFTC has adopted rules to address the treatment of customer collateral posted for cleared swaps, uncleared swaps, and futures contracts, options on futures, and commodity options. These rules require the segregation of customer funds within each of these types of accounts under different models, as discussed herein.

(i) Cleared Swap Accounts – LSOC Segregation Model

Under the "legal segregation with operational commingling" model ("LSOC Model"), all collateral for the cleared swaps customers of an FCM or DCO may be placed in one "omnibus" customer account of the FCM or a DCO.[80] However, the rules require the complete legal segregation of customer collateral from the FCM's or DCO's property. In the event of a clearing member FCM's bankruptcy, if there is a shortfall in the customer account that is attributable to a cleared swaps customer loss, and the shortfall exceeds both the customer's collateral and the FCM's ability to pay, the DCO may only use the collateral attributable to the customers whose portfolios of positions at the DCO suffered losses (as well as the assets of the FCM itself) to meet the loss. In connection with the LSOC Model, an FCM must provide the relevant DCO with daily information regarding the identity of the FCM's underlying customers whose positions are held in the account, each customer's portfolio positions, and the margin associated with those positions.

Although central clearing of swaps and posting of collateral is intended to reduce systemic risk, it will not entirely de-risk the swaps market. The LSOC Model includes the following risks:

- Creating a potential single point of failure by using a central clearing organization.
- Posting collateral to a central counterparty makes that collateral potentially available to an FCM or DCO if one counterparty defaults.

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78 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (EMIR). The NFC Protocol is available on the ISDA website at http://www2.isda.org/functional-areas/protocol-management/protocol/11.

79 The EMIR Protocol is available on the ISDA website at https://www2.isda.org/functional-areas/protocol-management/protocol/15.

80 CFTC Regulations Part 22.

- Creating contagion risk in that one party's default (including an FCM's) could spread and jeopardize all participants' cleared swaps collateral as a result of fraud, negligence, or operational mishap at the DCO, resulting in a shortfall in required collateral.

- Mutualizing risk to the extent that, if an FCM fails and there is a shortfall in required collateral, all cleared swap customers could face losses on a pro rata basis.

FCMs are generally not permitted to maintain margin for futures and options customer accounts in third-party custodial accounts, except in the case of FCMs that are ineligible to hold the assets of their registered investment company customers due to affiliation with the investment company or its adviser.[81] However, the CFTC does not impose a similar requirement on margin for cleared swaps, and an FCM may use a third-party custodial account for margin of cleared swap customers. The CFTC has stated that collateral in third-party accounts constitutes customer property within the meaning of the U.S. Bankruptcy Code, meaning that the customer posting margin via a third-party account may remain subject to the risk mutualization concerns discussed above.

Section 17(f) of the U.S. Investment Company Act of 1940 as amended ("1940 Act") requires a registered investment company to custody "securities and similar investments" with banks, or alternatively, subject to certain rules of the SEC, broker-dealers, or the fund itself. As a general matter, the SEC takes the position that margin or collateral is subject to Section 17(f) and that, absent relief thereunder, a fund must post margin or collateral with an eligible custodian.[82] Rule 17f-6 under the 1940 Act provides an exemption from Section 17(f) to allow registered investment companies to maintain initial margin in the custody of an unaffiliated FCM registered with the CFTC pursuant to certain requirements. Through a series of no-action letters, the SEC has extended Rule 17f-6 to cleared swaps, allowing funds or their custodians to satisfy margin requirements by placing margin in the custody of a DCO registered with the CFTC or a clearing member that is an FCM registered with the CFTC.[83]

(ii) Uncleared Swap Accounts – Election of Segregation

Swap dealers and major swap participants must notify their uncleared swaps counterparty that the counterparty may elect segregation of its initial margin in an account maintained by a custodian independent of both the counterparty and the swap dealer or major swap participant.[84] Swap dealers and major swap participants must comply with this rule by May 5, 2014 for uncleared swap

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81 Prior to 2005, the CFTC permitted a fund to enter into a tri-party control agreement with its FCM and custodian for the purpose of posting margin. In 2005, the CFTC issued an interpretative position to permit funds to place initial margin with an FCM (except in the case of a fund transacting with an affiliated FCM, which may still post margin pursuant to a control agreement). Amendment of Interpretation, 70 Fed. Reg. 24,768 (May 11, 2005).

82 Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, Investment Company Act Release No. 22389 (Dec. 11, 1996).

83 *See, e.g.,* Chicago Mercantile Exchange (Credit Default Swaps) (pub. avail. Sept. 27, 2012); Chicago Mercantile Exchange (Interest Rate Swaps) (pub. avail. Sept. 27, 2012); ICE Clear Credit LLC (pub. avail. Sept. 27, 2012); LCH Clearnet Limited (pub. avail. Sept. 27, 2012); Chicago Mercantile Exchange (Cash-Settled Commodity Index Swaps and Foreign Currency Swap Contracts) (pub. avail. July 10, 2013).

84 CFTC Regulation 23.701-02.

transactions with new counterparties or by November 3, 2014 for swap transactions with existing counterparties.

(iii) Futures and Options Accounts – Segregation and Residual Interest Requirement

Under the segregation rules applicable to the commodity futures and options markets, FCMs must separately account for and segregate futures and options customer funds and property from the FCM's property but may operationally comingle funds and property of all customers.[85] Traditionally, following a default of both an FCM and one or more futures and options customers, the DCO would be permitted to access the collateral of non-defaulting customers before applying its own assets or the guaranty funds of non-defaulting FCM clearing members.

However, under rules adopted in October 2013, FCMs and DCOs must maintain "residual interest" in customer accounts to cover any deficits in these accounts.[86] The amount maintained must be at least equal to customers' aggregate undermargined amounts for the prior trade date (as discussed herein).[87] The rule also prohibits FCMs and DCOs from using the excess margin in one customer account to cover the deficit in another customer account.

Compliance dates for the residual interest requirement will be phased in over a five year period. The CFTC will study the rule over the next 30 months and may change the deadline for posting the required collateral during this time.

- During the first year – no changes will occur.
- Beginning November 14, 2014 – FCMs must post the required collateral by 6:00 p.m. (U.S. East Coast Time) on the date of settlement of the trade, which is the day after the trade occurs.
- Beginning December 31, 2018 – FCMs must post the required collateral at the time of settlement of the trade, which is the morning after the trade occurs.
- Beginning November 14, 2014, FCMs are required to take a capital charge for failure to meet their residual interest requirements by the stated deadline.

(b) Investment of Customer Funds

Futures, Options and Cleared Swaps Accounts: Customer collateral may only be invested pursuant to CFTC Regulation 1.25.[88] Regulation 1.25 limits FCMs' investment of collateral posted in connection with cleared swaps and exchange-traded futures and options to specific, limited categories of enumerated "permitted investments."

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85 CFTC Regulation 1.20.

86 *Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations*, 78 Fed. Reg. 68506 (Nov. 14, 2013).

87 CFTC Regulations 1.20(a) and 1.22.

88 CFTC Regulations Part 22.

Uncleared Swaps: Under new rules adopted in October 2013, once effective, margin that swaps counterparties have elected to be segregated may only be invested in accordance with CFTC Regulation 1.25.[89]

(c) Other New Customer Protection Rules

The CFTC adopted a number of new rules that are designed to afford FCM customers greater protection, including:

- Monitoring of withdrawals from customer segregated or secured accounts.[90]
- New risk management programs and organizational requirements.[91]
- Enhanced reporting, recordkeeping, and disclosure rules.[92]
- New rules for self-regulatory organizations and certified public accountants.[93]
- Updates to FCM bankruptcy rules.[94]

VI. BLOCK TRADES

Dodd-Frank and CFTC regulations require the real-time reporting of swap transaction and pricing data.[95] Dodd-Frank also provides an exception to the real-time reporting requirement for certain large swaps by requiring the CFTC to establish "the criteria for determining what constitutes a large notional swap transaction (block trade) for particular markets and contracts" and "the appropriate time delay for reporting [such large trades] to the public."[96] On May 31, 2013, the CFTC published the minimum block trade sizes for different types of swaps that may be executed off-facility and with a time delay in public reporting.[97] If a swap is traded in a notional amount above a specified minimum size, the swap may be reported to the public on a delayed basis and need not be traded on a SEF or DCM.

Whether an investment adviser needs written consent from its clients and whether an investment adviser may aggregate the orders of various clients to meet the minimum order sizes to take advantage of this relief depends on whether the particular trade is classified as a "block trade" or a "large notional off-facility swap." In general, a block trade is a large trade that involves a swap

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89 CFTC Regulation 23.703.

90 CFTC Regulation 1.23(d).

91 CFTC Regulations 1.11 and 1.16.

92 CFTC Regulations 1.12 and 1.55.

93 CFTC Regulation 1.52.

94 CFTC Regulation 190 to reflect cleared swaps, SEFs, and current swap market practices.

95 CEA Section 2(a)(13).

96 CEA Section 2(a)(13)(E).

97 Procedures To Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 78 Fed. Reg. 32866, 32870 (May 31, 2013) ("Block Trade Adopting Release").

that is listed on a SEF or DCM, which would have been executed on the SEF or DCM but for its large size and is otherwise executed pursuant to the SEF or DCM's rules and procedures. A large notional off-facility swap is not subject to the rules and procedures of a SEF or DCM.

(a) Obtaining Client Consent

If the transaction is a large notional off-facility swap, no client consent is required. However, if the transaction is a block trade, the investment adviser will need to have an express consent from its clients in the applicable investment management agreements.[98] A general grant of investment management discretion is not adequate.[99]

(b) Aggregating Orders Across Multiple Clients

An investment adviser may aggregate the orders of multiple clients to reach the specified minimum notional size for block trades (but not for large notional off-facility swaps), provided that the following requirements are met:

(i) aggregation is permitted on the relevant SEF or DCM;[100]

(ii) the investment adviser has more than $25 million in assets under management;[101] and

(iii) the investment adviser is:

(A) a registered or exempt CTA which has discretionary trading authority or directs client accounts,[102]

(B) a registered investment adviser ("RIA") which has discretionary trading authority,[103] or

(C) a foreign equivalent to a CTA or RIA.[104]

In addition, the aggregated orders must be executed as a single swap order and may not be aggregated after they have been executed.[105] Furthermore, while CFTC regulations do not expressly require client consent for aggregating positions with other clients in order to reach the

98 CFTC Regulation 43.6(i)(2).

99 Block Trade Adopting Release, at 32906.

100 CFTC Regulation 43.6(h)(6).

101 CFTC Regulation 43.6(h)(6)(ii).

102 CFTC Regulation 43.6(h)(6)(i)(A).

103 CFTC Regulation 43.6(h)(6)(i)(B).

104 CFTC Regulation 43.6(h)(6)(i)(C).

105 CFTC No-Action Letter No. 13-48 (Aug. 6, 2013), at 3.

minimum block trade size, the adopting release to those regulations suggests that such consent must be obtained.[106]

VII. POSITION LIMITS

Dodd-Frank amended the CEA to direct the CFTC to establish position limits for futures and options contracts traded on a DCM as well as swaps and other contracts that are economically equivalent to such contracts.[107] On November 18, 2011, the CFTC published a comprehensive set of regulations on speculative position limits on exchange-traded futures and options contracts and economically-equivalent OTC derivatives referencing 28 individual agricultural, metal, and energy commodities.[108] The regulations also required market participants to aggregate position limits across accounts and positions they control, subject to certain exceptions. On May 30, 2012, the CFTC published proposed modifications to its policy for aggregation under the CFTC's new position limits regime.[109] On September 28, 2012, the CFTC's position limit regulations were vacated by the U.S. District Court for the District of Columbia and remanded to the CFTC.[110]

On November 5, 2013, the CFTC proposed a new set of position limit regulations and aggregation standards.[111] The new proposal largely mirrors the vacated final regulations, but differs in a number of respects. For example, the new proposal narrows the exemption from position limits for *bona fide* hedging by eliminating exemptions for anticipatory hedging and adds a significant exemption to the spot month limit for cash-settled contracts where the trader does not hold any physically-delivered contracts in the same commodity. The proposal also expands upon the circumstances under which aggregation is not required.

(a) Setting Position Limits

The calculations of position limits in the proposed regulations are substantially similar to the vacated ones, and position limits will be set with the following procedure:

- Spot-month position limits will generally be set at 25% of estimated deliverable supply, with initial limits set at levels currently in place at DCMs. Spot month limits will be applied separately for physical-delivery and cash-settled contracts, and traders cannot net positions across the two categories of contracts.

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106 Block Trade Adopting Release, at 32906.

107 CEA Sections 4a(a)(2) and 4a(a)(5).

108 *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71626 (Nov. 18, 2011) (codified at 17 C.F.R. pts. 1, 150, 151).

109 *Aggregation, Position Limits for Futures and Swaps*, 77 Fed. Reg. 31767 (May 30, 2012).

110 *Int'l Swaps and Derivatives Association v. U.S. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012).

111 *Position Limits for Derivatives*, Commodity Futures Trading Comm'n (Nov. 5, 2013), http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110513c.pdf (to be codified at 17 C.F.R. pts. 1, 15, 17, 19, 32, 38, 140, 150); *Aggregation of Positions*, 78 Fed. Reg. 68946 (proposed Nov. 15, 2013) (to be codified at 17 C.F.R. pt. 150).

- Non-spot month contracts (*i.e.*, single month and all-months-combined) position limits will be set using a "10/2.5 percent formula": 10% of the contract's first 25,000 of open interest and 2.5 percent of further open interest. The proposed regulations permit netting across physical-delivery and cash-settled contracts for non-spot month limits.

The proposed regulations permit traders to hold cash-settled spot-month positions in any referenced commodity at a level five times greater than the spot-month limit, but only if the trader does not hold *any* physical-delivery spot-month contracts in the same referenced commodity. The vacated regulations, by contrast, established the same limits for cash-settled and physical-delivery contracts except that they permitted traders in certain natural gas contracts to hold cash-settled spot-month positions at a level five times greater than the spot-month limit, subject to certain conditions.

(b) Exemptions to Position Limits

As with the prior vacated regulations, positions in futures, options, and swaps entered into in good faith prior to the effective date that exceed position limits are proposed to not be considered in violation of the regulations. Diversified commodity index contracts are expressly excluded from the scope of these regulations.

The *bona fide* hedging exemption under current CFTC regulations is narrowed under the proposed regulations. Specifically, the proposed regulations remove some exemptions for certain types of anticipatory hedging and limit the *bona fide* hedging exemption to specific hedges. Additionally, the proposed regulations eliminate the existing process for seeking a non-enumerated exemption for *bona fide* hedging. While the CFTC retains its exemptive authority under the CEA, the proposed regulations do not prescribe a specific process under which an affected trader may seek a non-enumerated exemption.

(c) Aggregation of Positions

The proposed aggregation regulations reference the existing aggregation scheme contained in Part 150 of CFTC Regulations and are substantially similar to the proposed May 2012 amendments to the vacated regulations. The proposed aggregation regulations expand the available exceptions to aggregation by creating four new contexts in which positions need not be aggregated:

1. Where the sharing of information necessary to aggregate positions "would violate or create reasonable risk of violating U.S. Federal or state or foreign jurisdiction law or regulation" (subject to a notice filing with a memorandum of law explaining the reason for the exemption).

2. Where the market participant has an ownership interest of 50% or less in another entity, but such other entity's trading is independently controlled (subject to a notice filing).

3. Where the market participant has an ownership interest of greater than 50% in another entity, but the CFTC finds in its discretion (among other things) that the other entity is not consolidated with the applicant under U.S. generally accepted accounting principles, the other entity's trading is independently controlled, the applicant certifies to the CFTC in a

notice filing that the other entity's positions qualify as *bona fide* hedging positions or do not exceed 20% of any applicable position limit, and complies with certain other conditions.

4. Where the market participant has an ownership in another entity solely as the result of broker-dealer activities in the normal course of business as a dealer.

The proposed regulations also modify the exemption from the position limit regime for "independent account controllers" ("IACs"), the required attributes of which are specified in the CFTC regulations.[112] The IAC concept is a long-permitted exemption from aggregation under the CFTC's position limit regulations. Under the IAC exemption, certain eligible persons (including registered or excluded CPOs or CTAs to registered investment companies and other types of funds)[113] that would ordinarily be required to aggregate all commodity interest positions in accounts or pools under their ownership or control are exempt from such aggregation if they delegate trading authority over those accounts or pools to an IAC that independently controls trading decisions without the day-to-day direction of the delegator and other conditions are satisfied. Among other things, the proposed changes to the IAC definition extend the IAC concept beyond the proposed 2012 amendments to treat an investment manager of an employee benefit plan sponsored by a corporate entity as an IAC, thus permitting the sponsoring entity to avoid aggregating the positions of the plan with its other trading activities.

These changes apply to the CFTC's existing position limit regime as well as the proposed regime.

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[112] CFTC Regulation 150.1(e).

[113] CFTC Regulation 150.1(d).

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What Should I Be Worrying About Now? Current Compliance and Enforcement Issues

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Social Media Usage in the Financial Services Industry: Toward a Business-Driven Compliance Approach

Social media use by the financial services industry is prevalent and can be expected to grow as the social networks continue to expand and become further entrenched in the public's online consciousness. However, the industry has lagged behind its corporate peers, likely due to regulatory concerns. In the authors' view, however, regulatory concerns or uncertainty should not lead to paralysis, but instead should be considered in the context of the business purposes behind a financial services firm's intended use of social media. Firms that have a clear business purpose in mind will not only be more effective in their online interactions, but will also have a better understanding of the risks involved. The authors identify four major purposes for which financial services firms might use social media, and explain the issues involved and potential pitfalls to be avoided.

RAJIB CHANDA AND STEVE ZAORSKI

Within the past decade, participation in social media and online communities has become a routine part of peoples' daily lives. To capitalize on this phenomenon, a large percentage of major companies and brands have developed active online presences through an assortment of social media outlets. However, the financial services industry has seemingly lagged behind its corporate peers, largely, we believe, as a result of regulatory concerns. In our view, however, regulatory concerns or uncertainty should not lead to paralysis, but instead should be considered in the context of the business purposes behind a financial services firm's intended use of social media. When considered in that context, the primary issues worthy of consideration will become clearer, enabling a firm to develop tailored policies and procedures that do not inhibit successful social media initiatives.

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OVERVIEW OF REGULATORY LANDSCAPE

In the last two years, the regulatory landscape for the financial services industry has been shaped by the release of guidance from the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).[1] This article does not purport to summarize that guidance, which has been amply summarized elsewhere.[2] We note that some financial

[1] See SEC, Office of Compliance Inspections and Examinations, "National Examination Risk Alert: Investment Advisor Use of Social Media" (Jan. 4, 2012), available at http://www.sec.gov/about/offices/ocie/riskalert-socialmedia.pdf [hereinafter "SEC Risk Alert"]; FINRA, "Social Media Websites and the Use of Personal Devices for Business Communications: Guidance on Social Networking Websites and Business Communications" (Regulatory Notice 11-39, Aug. 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p124186.pdf; FINRA, "Social Media Web Sites: Guidance on Blogs and Social Networking Web Sites" (Regulatory Notice 10-06, Jan. 2010), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120779.pdf.

[2] See, e.g., Martin Fox, Jack P. Huntington, & Bruce Treff, "Use of Social Media by Investment Advisers," 44(19) Rev. of Sec. & Commodities Reg. 237 (2011), available at http://www.citibank.com/transactionservices/home/securities_svcs/docs/social_media_investment.pdf; Rajib Chanda & Todd Menszak, "Ten Things to Know About Social Media in the Financial Services Industry," 2 Social Media L. Rep. 1 (Jan. 2, 2013).

industry analysts have derided this guidance as "very strict" and have complained that it "make[s] it so difficult that it's useless,"[3] while others have taken a more sober approach to the guidance, recognizing that its laundry list of potential pitfalls is no more extensive than any parade of horribles that could be imagined for activities by highly regulated entities.

There are two fundamental issues with the guidance that has been provided thus far. First, it assumes that the only use for social media is branding or advertising, and largely repurposes advertising rules and regulations into a new context, without acknowledging that social media can be used for business purposes beyond traditional advertising.[4] Second, and relatedly, the guidance ignores myriad other issues that firms should consider when adopting social media compliance policies, which we argue could be more relevant for some firms depending on their business purpose for using social media. The biggest question for the financial services industry remains finding a compelling business reason to engage in social media. This article will address the core business purposes for financial firms to use social media and it will analyze the tension between these purposes and the evolving compliance regime. By having specific goals and understanding the compliance rules impacting those goals, financial firms will be better suited to address where the risks lie and how best to navigate them.

In the coming years, it is only reasonable to expect that social media will become even more widely adopted by the financial services industry as the younger generation—which grew up following Facebook status updates and tweeting at their favorite celebrities—begins to accumulate capital that needs to be properly allocated.

EMERGENCE OF SOCIAL MEDIA IN THE FINANCIAL SERVICES INDUSTRY

As a highly regulated industry, the financial services sector has been slower than other corporate sectors to adopt social media for business purposes.[5] Nonetheless, according to a 2011 SocialWare study of financial advisers in North America, as of September 2011 more than 84 percent of such advisers use social media for business purposes.[6] This percentage is a marked increase from the 60 percent of advisers who used social media in 2010.[7] Among the 84 percent who used social media for business purposes, approximately 65 percent stated that they used social media every day, ranging from at least five minutes to one hour of usage.[8] This rapid acceleration in the adoption of social media by the financial services industry seems to be driven by the confluence of three favorable factors: (1) advancements in consumer and corporate technology (e.g., widespread adoption of smartphones, such as Apple's iPhone and Google's Android); (2) consumers' increased comfort with new technologies and channels (e.g., online and mobile banking); and (3) a somewhat more predictable regulatory environment, largely thanks to the aforementioned SEC and FINRA guidance.[9] Social media use by the financial services industry has also accelerated as more financial firms discover that social media platforms are a natural complement to their business. Social media has the potential to enhance relationships with customers and develop trust, while financial firms are similarly focused on managing relationships and building trust, as well as prospecting for new clients and talented employees. Underlying this acceleration is, of course, the explosion of social media usage by the adult population generally; a recent report shows that an estimated 91 percent of adults use social media regularly[10] and online social networking now accounts for nearly one in every five minutes spent online globally.[11] In the coming years, it is only

[3] Lisa Shidler, "SEC Sends Sharp Warning to Advisors Using Social Media" (RIABiz, Jan. 6, 2012), available at http://www.riabiz.com/a/10666007.

[4] For an approach that acknowledges such broader uses, see the recent proposed guidance by the Federal Financial Institutions Examination Council, Social Media: Consumer Compliance Risk Management Guidance, Docket No. FFIEC-2012-0001 (January 22, 2013).

[5] See Michael Veenswyk, "Why Has the Financial Services Sector Been Slow to Adopt Social?" (Econsultancy Blog, Feb. 26, 2013, 11:22 AM), available at http://econsultancy.com/us/blog/62215-why-has-the-financial-services-sector-been-slow-to-adopt-social.

[6] Executive Summary: Social Media Use by Financial Advisors, Social Ware (Sept. 2011) (explaining the increasing use of social media by financial advisors), available at http://www1.socialware.com/rs/socialware/images/2011%20Financial%20Advisor%20Survey-Executive%20Summary.pdf.

[7] Id.

[8] Id.

[9] SEC Risk Alert, supra note 1; FINRA, Regulatory Notice 11-39, supra note 1; FINRA, Regulatory Notice 10-06, supra note 1.

[10] IBM Software, Grasping the Power of Social Networking for Financial Services (2012), available at http://smcapture.com/documents/Power%20of%20Social%20Networking%20for%20Financial%20Services.pdf.

[11] Press Release, It's a Social World: Social Networking Leads as Top Online Activity Globally, Accounting for 1 in Every 5 Online Minutes (comScore, Dec. 21, 2011), available at http://www.comscore.com/Press_Events/Press_Releases/2011/12/Social_Networking_Leads_as_Top_Online_Activity_Globally.

reasonable to expect that social media will become even more widely adopted by the financial services industry as the younger generation—which grew up following Facebook status updates and tweeting at their favorite celebrities—begins to accumulate capital that needs to be properly allocated.

BARRIERS TO FINANCIAL INSTITUTION ENTRY

Even though social media has been more rapidly adopted in recent years, there are still a number of financial firms that are choosing to sit on the sidelines, and others are only tepidly experimenting with social media, rather than fully embracing this new form of marketing and networking. At least two hurdles stand in the way of industry embrace:

- Firms lack a compelling business purpose to adopt these media, and in any case are unsure about how to properly leverage them; and
- Firms are worried about complying with the raft of existing regulations in the financial services sector.

In regard to the first hurdle, one might surmise that the financial services industry traditionally has a conservative culture that prefers methods with a proven track record rather than venturing into uncharted territory. Further, many financial service professionals do not think potential Twitter followers and Facebook friends would be interested in the type of information that they would want to share. Simply put, many financial firms worry about being too boring for these cutting-edge platforms (or being forced to be too boring once all the rules and regulations are complied with).

As for the second hurdle, close to 91 percent of financial industry professionals claim that "compliance" is the biggest stumbling block to greater social media use.[12] These professionals are troubled by the lack of clear guidance from FINRA and/or the SEC on how to properly use social media, a concern which only becomes more troublesome as the social media platforms continually innovate and alter functionalities. Financial firms are also concerned about the costs associated with compliance, such as hiring lawyers to draft social media policies or licensing new software to retain all social media interactions.

To further complicate matters, there is an inherent tension that exists between these two hurdles. While overcoming the first hurdle would require financial firms to break out of their mold and engage in new forms of social interactions, the second hurdle promises to trip them up by limiting the manner and content of these interactions. To deal with these challenges, we propose a schematic for thinking about the business purposes for using social media for financial services firms, and then identify the main compliance challenges attendant with the specific business purposes. By categorizing a firm's social media needs according to business purpose, our hope is that firms will be able to identify the key areas of concern from a compliance perspective, rather than getting lost in a host of potential issues.

BUSINESS PURPOSES FOR USING SOCIAL MEDIA

Successful social media strategies and compliance policies should be focused on promoting the underlying purpose of the communication. On a macro level, one way of conceiving of social media communications is measuring how well the communications satisfy an "unmet" social need.[13] For instance, one unmet social need may be fostering relationships among potential or existing clients, such as a group of like-minded parents who are looking for prudent and effective ways to save for their children's college educations. For many industries, including financial services, this focus on social needs may represent a paradigm shift. Most businesses are used to "helping people meet their economic needs rather than their social needs."[14] However, a successful social media strategy could help people form and strengthen relationships in ways that benefit the businesses' bottom-lines.[15] Indeed, social media has even changed the ways that businesses calculate the impact of such marketing on the bottom-line (typically known as the "return on investment" or ROI). Measuring the ROI of social media is not a perfect science, but it is fairly different than traditional ROI calculations. Rather than simply measuring ROI in terms of a direct increase in sales or a jump

Many financial firms worry about being too boring for these cutting-edge platforms (or being forced to be too boring once all the rules and regulations are complied with).

[12] Diana Britton, "Registered Rep/Wealth Management.com Research: Indies, Insurers Take Lead on Social Media" (wealthmanagement.com, Oct. 19, 2011), available at http://wealthmanagement.com/practice-management/registered-repwealth-managementcom-research-indies-insurers-take-lead-social-med.

[13] See Mikołaj Jan Piskorski, "Social Strategies That Work," 89(11) Harv. Bus. Rev. 116 (Nov. 2011).

[14] Id.

[15] See id.

in a firm's client base, ROI in the social media realm can also be measured in terms of driving traffic to the firm's website, increased online chatter regarding the firm's brands or products, an uptick in e-mail registrations, or an increased awareness of a firm's identity, expertise, and role in the marketplace relative to its competitors—to name only a few.[16] Fortunately, numerous software companies have produced analytics programs that can help companies collect a host of information about the social media tactics that work and the strategies that establish the strongest connections between the company and the user both online and offline. Furthermore, the ROI of social media should go beyond the usual metrics since it is more about "helping people, communicating [firm] values and reaching people who care about what [the firm has] to say" according to Vanguard's social media principal, John Buhl.[17] Additionally, most social media platforms are free to join and to use, so these efforts can also help reduce marketing and customer service budgets over the long-term.

To help people create and maintain the social relationships that are at the core of a successful social media strategy, the business must have a specific, chosen purpose (or purposes) for its social media interactions. The biggest social media pitfall any business should avoid is the practice known as "provide and pray."[18] In the "provide and pray" model, the business provides access to the technology, such as by creating a Facebook page or a Twitter account, and then prays that a community forms or interactions start occurring among the business' followers in such a way that it benefits the business.[19] While communities may form and interactions may occur, they will most likely not be of any value to the company because it is not steering the conversation in a direction that comports with its business goals. A specific, designated purpose is important because it "becomes the cause around which people will rally and be inspired to act."[20] For any business, including the financial services industry, we believe the specific purpose for adopting social media will most likely fall into one of four categories:

- Branding or advertising;
- To form and mobilize a community or group;
- To take advantage of the live search capabilities facilitated by social media platforms; and
- To provide efficient and cost-effective customer service.[21]

In the following sections, we discuss each purpose, along with the risks and regulations that affect financial services companies as they try to achieve the respective purposes.

BRANDING OR ADVERTISING

Effective Use of Social Media. As any Facebook user would most likely attest, one of the key features that promotes return trips to Facebook's site is the newsfeed. The newsfeed is the centerpiece of the Facebook interface and it is a "constantly updating list of stories from people and Pages"[22] (including businesses and organizations) that a user "friends" or "likes" on Facebook. This simple list enables users to catch up on all the information that their friends have pushed out recently and it allows users to comment on or "like" this information. In a similar fashion, LinkedIn also provides a "newsfeed" that enables users to see changes that their "connections" have made to their profiles—new jobs, new degrees, new work experiences, etc. Meanwhile, the Twitter experience almost entirely centers on a constantly updating list of status updates, limited to 140-characters, posted by Twitter users that one chooses to "follow."

Being listed on a user's newsfeed or Twitter feed is crucial to a business's marketing efforts. The newsfeed enables businesses to push out information directly to the users who follow them, akin to a RSS feed about the company. This functionality essentially enables a business to provide unlimited free advertising for new products, deals, and promotions, and it can also be used to help develop a company's brand. Therefore, being included on a user's newsfeed or Twitter

[16] See Amy McIlwain, "How Can You Gauge the ROI of Social Media Marketing?" (Ignites, Nov. 14, 2011), available at http://www.ignites.com/c/274131/32581?referrer_module=searchResults&module_order=1&q=gauge+the+ROI&sort_by=date.

[17] Maura McDermott, "Use @ Ur Own Risk, SEC Suggests in Social Media Alert" (BoardIQ, Jan. 24, 2012), available at http://www.boardiq.com/c/303332/35412?referrer_module=searchResults&module_order=1&q=use+%40+ur+own+risk&sort_by=date.

[18] Anthony J. Bradley & Mark P. McDonald, "Social Media Success Is About Purpose (Not Technology)" (Harv. Bus. Rev. Blog Network, Nov. 1, 2011, 2:57 PM), available at http://blogs.hbr.org/cs/2011/11/social_media_success_is_about.html.

[19] See id.

[20] Id.

[21] This categorization of the four purposes for social media use was developed by Rajib Chanda, one of the co-authors of this article, and Kathie Legg, formerly Senior Mobile and Social Media Manager of Obama for America, in 2011. See Chanda & Menszak, supra note 2.

[22] "What Is News Feed?" (Facebook), available at http://www.facebook.com/help/#!/help/210346402339221/ (last visited Dec. 19, 2012).

feed is an invaluable resource for a business, but the challenge for most businesses is gaining access to the newsfeed in the first place.

While a marketing professional may be better suited to provide specific examples of tactics that a financial firm can use to gain followers, there are a few general principles that should guide the process.

Do Not Use Social Media as a Direct Marketing Platform. People who use social media platforms are engaging these networks for a reason, whether it is to keep up with high school classmates, to network with potential employers, or to discover what Kim Kardashian had for breakfast. They are not using social media to be inundated by offers for credit cards or home loans. These are the type of status updates or tweets that usually discourage potential or current followers. In contrast, people tend to follow, share, like, or retweet[23] posts that align with and/or help promote the individual social media user's "brand." People engage social media to share information about themselves with their networks, so the information must strike a chord with that user. Therefore, it is important that financial services companies make themselves useful to the individual, rather than attempting to force feed their information to current or potential followers.

Give Your Followers What They Want, Not What the Company Needs to Push Out for Marketing Purposes. As discussed earlier, one goal of social media could be to satisfy social needs rather than economic ones. This means that companies should not clutter a user's valuable newsfeed space with promotions. Instead, tailor the company's message to what the user needs.

> ***Example:*** If a community bank exists in a neighborhood with a lot of young families, the bank should consider sharing trade journal articles about saving for college with its followers. This will be more effective than trying to directly sell its 20-year certificates of deposit or high-yield savings accounts to its followers. The sharing of helpful information is an approach that will put the bank on followers' radars, while also allowing the bank to show its "human side" (rather than being seen as solely driven by turning a profit). If a follower enjoys the article and "likes" it or comments on it, then the bank has begun to foster a relationship that might lead to more business in the future or even recommendations to friends in the community.

As a recent study has shown, 79 percent of U.S. Twitter users are more likely to recommend brands that they follow and 67 percent are more likely to buy from brands that they follow.[24] Furthermore, most people place more trust in the recommendations of their own friends and family because they are familiar with their tastes and proclivities. It can be a powerful endorsement for a company if someone's friend and/or family members choose to "like" a particular brand or write a positive review on Yelp. In the social media age, a company's most powerful advertisement might not be the creative or funny commercial that cost thousands of dollars to create; rather, it is the "word-of-mouth" endorsements that can spread quickly and cheaply through individual followers' social networks.

People are not using social media to be inundated by offers for credit cards or home loans. It is important that financial services companies make themselves useful to the individual, rather than attempting to force feed their information.

Regulatory Concerns. While the newsfeed is an invaluable resource for financial services companies, there are also important regulations limiting what such companies can say on these platforms when they are used for branding or advertising purposes. Similar to any other communication from a financial firm, all social media communications must conform to the anti-fraud provisions of the securities laws and, potentially, those of the Federal Trade Commission (FTC), including but not limited to ensuring that communications do not contain any untrue statement of material fact or be otherwise misleading.[25]

Financial firms, specifically broker-dealers, must be careful to not run afoul of the suitability requirement. If a broker-dealer or its personnel recommends a security through a social media platform, then it must ensure that the recommendation is suitable for every investor to whom it is made.[26] In a similar

[23] A "retweet" is when a Twitter user chooses to tweet content, with attribution, that has been previously posted by another user.

[24] IBM Software, supra note 10.

[25] See, e.g., 15 U.S.C. § 77q(a), 15 U.S.C. § 78j(b), 17 CFR § 240.10b-5, 15 U.S.C. §§ 806-6(2), 806-6(4), and 17 CFR § 275.206(4)-1; see generally, 15 U.S.C. § 45(a).

[26] See FINRA Rule 2310; FINRA, Regulatory Notice 10-06, supra note 1.

fashion, financial firms pursuing a private offering of securities must ensure that their social media use does not violate the ban on general solicitations (at least as it exists currently pending rules pursuant to the recently-enacted JOBS Act).[27]

Appropriate Supervision of Employees who "Post." If a firm chooses to let employees engage in social media for business purposes, the most troublesome risk of using social media updates for branding or advertising purposes is that the financial firm will violate applicable supervisory requirements. Most sophisticated organizations require some approval process before communications on behalf of the company are made, but those approval processes are usually driven by business and marketing concerns, not legal and compliance ones. For financial services firms, it is important to consider whether a legal or compliance overlay in the approval process is necessary. Firms will also need to think about whether employees who engage in the use of social media for business purposes should make their passwords available to their employer, so that compliance professionals can swiftly take down offending posts or otherwise control the account if the employee leaves the firm.[28] However, collecting such password information may not be permitted depending on the particular state in which an employee works.[29]

A "static" communication—such as a Facebook or a LinkedIn profile—is considered an "advertisement" and requires principal approval prior to use. Non-static, real-time communications—such as a Facebook wall post or a responsive tweet—do not need prior principal approval but should be supervised by the firm.

With respect to pre-approval of communication, in Regulatory Notice 10-06, FINRA divides the social media realm into "static" and "interactive electronic" forums for registered broker-dealers. If the communication is "static"—such as a Facebook or a LinkedIn profile—then it is considered an "advertisement" and requires principal approval prior to use.[30] If the posted content is non-static, real-time communications—such as a Facebook wall post[31] or a responsive tweet—then the information does not need prior principal approval but it should be supervised by the firm.[32] This supervision may take various forms, such as post-use sampling or lexicon-based search methodologies.[33]

It is important to note that interactive content can become static content if the interactive content is copied or re-posted to a static forum such as a blog or Facebook profile and thus, the rule above for static content will apply. Fortunately for the financial services industry, with respect to interactive content, FINRA has "backed away from a proposal that would have required broker-dealers to file social media postings with the regulator," although in certain circumstances, mutual fund firms may need to file static or interactive content as a result of SEC rules.[34] Nonetheless, financial services companies have dealt with this tricky dichotomy in different ways. For example:

- Morgan Stanley has reportedly launched a pilot program that takes the approach of allowing employees to use only a pre-approved library of tweets.[35]
- Raymond James reportedly allows its employees to generate original messages (in addition to choosing from a library), but these original messages are screened—typically on the same day, before posting—even though the firm has taken the

[27] 17 CFR § 230.501-.508 (2012); 17 CFR 230.502(c) (2012). Jumpstart Our Business Startups (JOBS) Act, P.L. 112-106 , 126 Stat. 305 (2012).

[28] Firms should also consider making it clear that they own the accounts under which business is being conducted, perhaps in an employee manual. See Complaint, Phonedog v. Kravitz, No. C 11-043474 MEJ (N.D. Cal. Nov. 8, 2011); John Biggs, "A Dispute Over Who Owns a Twitter Account Goes to Court," N.Y. Times, Dec. 26, 2011, at B1.

[29] Currently, Maryland, Delaware, Michigan, California, Illinois, and New Jersey have such restrictions. See David Kravets, "6 States Bar Employers From Demanding Employee Passwords," (Wired, Jan. 2, 2013), available at http://www.wired.com/threatlevel/2013/01/password-protected-states/.

[30] FINRA, Regulatory Notice 10-06, supra note 1.

[31] The Facebook wall is a section of a user's profile where other users can post comments, pictures, and video. The user has control over which other users can view the wall.

[32] FINRA, Regulatory Notice 10-06, supra note 1.

[33] Id.

[34] See Dan Jamieson, "Tweet Away: FINRA Backs Off Social-Media Posting Regs" (InvestmentNews, Dec. 30, 2011, 1:47 PM), available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20111230/FREE/111239990; SEC Division of Investment Management, Guidance Update: Filing Requirements for Certain Electronic Communications (March 2013), available at http://www.sec.gov/divisions/investment/guidance/im-guidance-update-filing-requirements-for-certain-electronic-communications.pdf.

[35] Josh Brown, "Raymond James Gets Social Media Right" (Wall St. J. Wealth Management Blog, Nov. 10, 2011, 7:48 AM), available at http://blogs.wsj.com/financial-adviser/2011/11/10/raymond-james-gets-social-media-right/.

position that such review is not necessary under the regulations.[36]

The SEC also addressed monitoring requirements for investment advisers, but the SEC's position largely leaves the frequency of such monitoring up to each firm.[37] The SEC simply requires investment advisers to monitor social media interactions and it encourages firms to consider the following factors in making their determination regarding the frequency of such monitoring:

- The volume and pace of such social media communications; and
- The probability of misleading communications being found within certain conversation streams.[38]

The SEC also leaves any pre-approval of social media communications to the discretion of each financial firm, unless the firm is also a member of FINRA and thus is required to comply with FINRA's more stringent guidelines.

Recordkeeping Concerns. Regardless of the business purpose underlying the use of social media, it is absolutely vital that a financial services company remains mindful of its recordkeeping responsibilities. Every financial services firm that intends to communicate through social media platforms must ensure that it can retain records of those communications as required by Rule 204-2 of the Advisers Act, Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (the "Exchange Act"), and FINRA Rule 3110, as applicable.[39] Beyond the rules, however, recordkeeping is a paramount compliance concern because of the increased regulatory or enforcement risk that can result from poor recordkeeping. Because records are the only way to demonstrate compliance with any applicable requirements, poor recordkeeping is low-hanging fruit for regulators—easy to identify and a basic requirement of being a regulated entity.

Of course, recordkeeping may be easier said than done, although it is relatively straightforward if a firm is using social media solely for branding and advertising. For that type of use, most communications that are required records are created by the firm or its employees, as opposed to third parties, and so long as you have the ability to capture the feeds, a large part of the recordkeeping responsibility will be satisfied. Some firms use third-party or proprietary software to do so, while others use more manual processes such as screen shots on a periodic basis or diverting posts into an RSS feed that is captured on a firm's network. We will revisit recordkeeping later in our discussion of more interactive uses of social media, and the challenges that those uses might pose in this regard.

Regardless of the business purpose underlying the use of social media, it is absolutely vital that a financial services company remains mindful of its recordkeeping responsibilities under Rule 204-2 of the Advisers Act, Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934, and FINRA Rule 3110, as applicable.

Bottom Line. Since most financial services firms are using social media for branding and advertising purposes, we believe that a compliance regime that focuses on anti-fraud training, suitability, supervision, and recordkeeping, while being mindful of particular state restrictions on matters such as collection of passwords, is the key to a successful compliance program for those firms. That is not to say that other issues raised by the SEC and FINRA in their respective guidance are not important, but that those issues can be considered ancillary to the key areas of risk that are raised by this type of social media usage.

FORMING AND MOBILIZING SOCIAL COMMUNITIES

Effective Use of Social Media. The ability to use social media to create formal and informal online groups or communities is arguably one of the

[36] See Tom Groenfeldt, "Raymond James Financial Advisors Get Social" (Forbes, Dec. 26, 2011, 3:55 PM), available at http://www.forbes.com/sites/tomgroenfeldt/2011/12/26/raymond-james-financial-advisors-get-social/; Bruce Kelly, "At Raymond James, It's a Valuable Tool for Communication" (InvestmentNews (June 17, 2012, 5:43 PM), available at http://www.investmentnews.com/article/20120617/REG/306179980.

[37] See SEC Risk Alert, supra note 1.

[38] Id.

[39] See FINRA, Regulatory Notice 10-06, supra note 1. FINRA rules require a firm to retain records of communications that relate to its "business as such" and this determination depends upon the facts and circumstances. For broker-dealers, Exchange Act Rule 17a-4(b) requires that firms preserve such records for a period of not less than three years and for the first two years the records must be kept in an easily accessible place. Meanwhile, registered investment advisers must retain such records in compliance with the federal securities laws, including in a manner that is easily accessible for a period of not less than five years under Advisers Act Rule 204-2. The type of device used to access the social media platform and whether the communication is static or interactive does not matter for record-retention purposes. The SEC Alert reminds companies in the financial industry that they need to train their employees on what constitutes a business communication and that they need to periodically monitor employees' compliance with this record retention responsibility. See SEC Risk Alert, supra note 1.

most revolutionary aspects of the platforms. On Facebook, there are pages that "allow organizations, businesses, celebrities and brands to communicate broadly with people who 'like' them," while groups provide a "closed space for small groups of people to communicate about shared interests."[40] The group functionality on LinkedIn is very similar to Facebook's model; however, it tends to revolve around the user's industry or educational connections. For example, LinkedIn has a social media law group through which lawyers and financial professionals are able to share articles and discuss recent developments. Twitter groups are more informal; they are formed by users who generate tweets and include a similar hashtag.[41] Perhaps the most dramatic display of the power of Twitter groups occurred during the "Arab Spring" as protesters across the Middle East used short tweets with an attached hashtag that were easily searchable by fellow protesters who wanted to join in or follow the growing movement.[42] Closer to home, the 2012 presidential election also inspired a number of social media groups that the candidates used to organize supporters, spread their policy agendas, share daily campaign videos, and even to fundraise.[43]

These types of communities existed online previously, in places like chat rooms and message boards. But the power of social media is that from one platform, a user can be a member of multiple communities at once, without having to go to multiple sites. Thus, social media groups or communities have enabled mass collaboration on a scale that has never before existed. With the click of a mouse, a person can be connected to multiple networks of like-minded individuals with whom that person can share ideas and get feedback in real time. Additionally, these communities of friends, or merely like-minded people, can become trusted sources for news, reviews, and recommendations for products.

A financial services company that is already leveraging social media groups for its advantage is American Express (AMEX). For the past three holiday seasons, AMEX has successfully used a Facebook group to promote "Small Business Saturday," which occurs the Saturday after Thanksgiving. This Facebook group, which is the core of the marketing efforts for this initiative, encourages followers to use their AMEX cards at a list of participating local small businesses. In exchange for patronizing these businesses, the individual is given a $25 credit on his or her credit card statement.[44] In 2011, more than 2.6 million consumers participated in the group on Facebook, which represented an increase in participation of over 73 percent.[45] In 2012, consumers spent $5.5 billion on Small Business Saturday, which surpassed the pre-holiday estimate of $5.3 billion.[46] Furthermore, small business owners could participate by joining the "American Express OPEN" group and gaining access to a small business toolkit.[47] AMEX's program is a helpful example because it demonstrates that satisfying consumers' social needs, such as mobilizing followers to shop locally for friends and family with the added incentive of a discount, can lead to the satisfaction of the business's needs, namely more people using their credit cards while making in-roads into the small business community. Other examples of successful community-building activities include Ameriprise, which has launched an investment adviser search tool through LinkedIn, and both E*TRADE and optionsXpress, which have launched their own social communities for investors to share tips and strategies.[48]

Many professionals worry about the potential for negative conversation streams about their firms. It is important to accept that negative chatter on the internet about a firm is always going to exist, whether or not that firm has an online presence. Having an active online presence through social media, however,

[40] "How are Pages different from groups?" (Facebook), available at http://www.facebook.com/help/210346402339221/#!/help/155275634539412/ (last visited Dec. 20, 2012).

[41] A hashtag is usually a word or phrase following the number symbol. For instance, every year football fans across America comment on the Super Bowl and most likely use the hashtag, #superbowl, so other football fans can view their comments on the game in real time.

[42] Uri Friedman, "The Egyptian Revolution Dominated Twitter This Year" (Foreign Pol'y Passport Blog, Dec. 5, 2011, 4:51 PM), available at http://blog.foreignpolicy.com/posts/2011/12/05/the_egyptian_revolution_dominated_twitter_this_year.

[43] See Sophie Quinton, "Social Engagement: What Happens When You 'Like' Barack or Mitt?" (Nat'l J., Apr. 22, 2012, 8:00 AM), available at http://www.nationaljournal.com/2012-presidential-campaign/social-engagement-what-happens-when-you-like-barack-or-mitt-20120422.

[44] Christina DesMarais, "Social Media, American Express Helping Holiday Shoppers Get Good Deals" (PCWorld, Nov. 26, 2011, 7:49 AM), available at http://www.pcworld.com/article/244951/social_media_american_express_helping_holiday_shoppers_get_good_deals.html.

[45] Id.

[46] Cheryl Winokur Munk, "Shoppers Spend $5.5 Billion on Small Business Saturday" (CNBC, Nov. 28, 2012, 9:47 AM), available at http://www.cnbc.com/id/49993064/Shoppers_Spend_55_Billion_on_Small_Business_Saturday.

[47] See Page for American Express OPEN, Facebook, https://www.facebook.com/Open (last visited Dec. 20, 2012).

[48] See Paul Taylor, "Financial Services Firms Embrace Social Media" (Fin. Times, Apr. 13, 2012, 10:59 PM), available at http://www.ft.com/intl/cms/s/0/5218321c-85a7-11e1-90cd-00144-feab49a.html.

allows the firm to become a part of the conversation stream, giving it an opportunity to minimize any negativity, clarify the situation, and respond directly to any concerns.

Regulatory Concerns. Social media groups and communities can be powerful tools for mobilizing large groups of people, but they also raise particular risks under the securities laws for the financial services industry. One such risk relates to third-party posts on a financial firm's social media profile or group page. If the firm is a registered broker-dealer, FINRA's position is that posts by third parties are not considered communications by the firm and therefore do not trigger the prior principal approval, content, and filing requirements.[49] However, a third-party post may become attributable to a registered broker-dealer if the firm has (1) "involved itself in the preparation of the third-party's content" (known as "entanglement") or (2) "explicitly or implicitly endorsed or approved the content" (known as "adoption").[50] For instance, a registered broker-dealer should not pay a third party to write on its Facebook wall or retweet a message from a third party whose content may run afoul of other FINRA requirements, such as suitability. According to FINRA, it is a best practice among the broker-dealer industry to establish appropriate usage and screening guidelines for third parties that are allowed to post on the dealer's social media platforms.[51] Registered broker-dealers also need to ensure that any links shared via their social media platforms do not connect to websites that the broker-dealer knows or has a reason to know contains false or misleading information.[52] In the SEC Alert, the agency did not take a clear position on third-party posts; instead, they left it to the discretion of the firm to determine what types of posts are permissible.[53]

Potential Liability for Third-Party Statements. The shortcomings of the FINRA and SEC guidance are revealed when one considers using social media for purposes beyond branding and advertising. If a firm actively wants to create a community and have engaged discussion, it must participate in that discussion, or in some other way promote it (by the creation of a hashtag for instance). If a firm creates a hashtag, does every post following that creation become a post "adopted" by or "entangled" with the firm? It is unclear from existing guidance, but we believe the better view is that they do not. This is because users of social media innately understand that they can take content that is available and repurpose it for their own ends, and the typical social media user would not mistake a comment by a third party as a statement by the firm itself. However, firms still must be careful not to retweet or "like" particular posts if they are not comfortable having liability for those statements, and thus we believe that firms that use social media to create and mobilize communities need to spend considerable time generating guidelines for when retweets and likes are permissible, and perhaps even require some pre- or post-approval for such actions.

Firms should also be aware that they may delete lewd, defamatory, or otherwise inappropriate third-party posts pursuant to Section 230 of the Communications Decency Act, and should be prepared to monitor and delete such posts if they are using social media as a way to form or mobilize a community.[54] This 1996 statue "immunizes social media and other websites from liability for content published by their users, provided that the site owners are 'not responsible in whole or in part, for the creation or development of' the offending content."[55] However, a firm should not view this statute as giving it a right to delete all posts that are negative. Indeed, deleting all negative posts could become a problem under the guidance issued by the FTC, which may be applicable to certain activities by financial services firms. The FTC's mandate is to protect consumers from "deceptive and unfair acts or practices" and only removing negative posts from a firm's social media streams may be construed as such an act since it could potentially mislead

It is important to accept that negative chatter on the internet about a firm is always going to exist, whether or not that firm has an online presence. Having an active online presence allows the firm to become a part of the conversation stream, giving it an opportunity to minimize any negativity, clarify the situation, and respond directly to any concerns.

[49] See FINRA, Regulatory Notice 10-06, supra note 1.

[50] Id.

[51] See id.

[52] See FIRNA, Regulatory Notice 11-39, supra note 1.

[53] See SEC Risk Alert, supra note 1.

[54] 47 U.S.C. § 230.

[55] See Cecilia Ziniti, "A Dirty Job: The Dirty.com Cases Show the Limits of CDA Section 230" (Socially Aware Blog, Apr. 26, 2012), available at http://www.sociallyawareblog.com/2012/04/26/a-dirty-job-thedirty-com-cases-show-the-limits-of-cda-section-230/.

consumers.[56] In addition, firms that use social media to form or mobilize groups or communities may be tempted to have employees post favorably about the company on those pages. This temptation must be avoided: The FTC has brought charges for deceptive advertising against companies that posted such reviews without disclosing that the posters were either being paid to do so or were employees of the company.[57]

Prohibited Testimonials. Another even more troublesome concern for the financial services industry when using social media to form or mobilize groups arises from the prohibition of testimonials, such as recommendations or endorsements on LinkedIn or even "likes" on Facebook, for investment advisers. Under Rule 206(4)-(1)(a)(1) of the Advisers Act, a recommendation or endorsement appearing on a user's social media profile could be seen in certain situations as a prohibited testimonial regarding an adviser's services or advice. In the SEC Alert, the agency has taken an even more hard-line stance, warning that if the "public is invited to 'like' an [advisor's] biography posted on a social media site, that election could be viewed as a type of testimonial prohibited by rule 206(4)-(1)(a)(1)."[58] While some financial firms may read these regulations and decide that it is best to avoid social media altogether, we believe that approach is shortsighted and fails to account for the ways to ameliorate the risks of incurring a prohibited testimonial.

> ***Example:*** A financial firm on LinkedIn may not be able to disable the recommendation or endorsement features, but the firm can "hide" the features so that they do not appear on the firm's profile. The recommendation or endorsement will still appear on the recommender's profile page, but the firm will arguably avoid liability, provided that it did not request the recommendation or endorsement (i.e., avoiding entanglement and adoption, by analogy to FINRA guidance, as previously discussed), since the firm itself is not advertising the testimonial.[59]

As for Facebook, some industry attorneys are making the draconian argument that financial services companies might want to consider not using the platform since a user must click the "like" button in order to follow a company on the site and add it to the user's newsfeed.[60] However, it is difficult to believe that the SEC intended to outright ban Facebook for the financial services industry since the SEC Alert did not clearly posit such a ban. A more measured view would be to take the position that the firm cannot actively solicit users to "like" posts regarding an adviser's products or services. Further, as most Facebook users know, clicking the "like" button to follow a company's page is not necessarily an endorsement of its products or services. Unlike on LinkedIn, where a recommendation serves as exactly that, the "like" button on Facebook is simply the functionality for connecting users on the platform; clicking it should not necessarily be seen as an endorsement of anything. In our experience, financial firms usually monitor their Facebook walls (often as frequently as daily) to ensure that any third-party testimonials are removed.

Recordkeeping. As discussed above, recordkeeping is a key consideration for all types of social media use by financial services firms. While FINRA, for example, generally does not treat third-party posts as associated with the firm unless the firm adopts the post or becomes entangled with it, the recordkeeping rules still require retention of these third-party posts if they relate to the firm's "business as such."[61] Even if the firm is going to delete the post from its social media profile, the retention requirements may still apply if this "business as such" standard is satisfied.

Firms will thus want to have a clear policy on which, if any, third-party posts will be maintained as records of the firm. We have seen several approaches in the industry, including:

- Preserving all communications (including deleted posts), similar to the way in which many firms retain all email;
- Preserving only those posts that are retweeted or liked by the firm or an employee, or posts that generated a direct response by the firm or employee; and

[56] See Bureau of Consumer Protection, Advertising and Marketing on the Internet: Rules of the Road (200), available at http://business.ftc.gov/documents/bus28-advertising-and-marketing-internet-rules-road.

[57] See Miguel Helft, "Charges Settled Over Fake Reviews on iTunes," N.Y. Times, Aug. 27, 2010, at B1.

[58] SEC Risk Alert, supra note 1.

[59] If employees seek to post professional biographies, an employer would also be able to direct its employees to disable, hide, or reject any recommendations or endorsements of the employee as a financial services professional. In imposing limits on employees' private social media activities, however, firms should be aware of federal and state laws that restrict an employer's ability to do so. See, e.g., Office of the Gen. Counsel, Div. of Operations Mgmt., Memorandum OM 12-59 (2012), available at http://www.theemployerhandbook.com/NLRBThirdReport.pdf.

[60] McDermott, supra note 17.

[61] FINRA, Regulatory Notice 11-39, supra note 1.

- Not preserving any third-party posts on the theory that those posts are not generated by the firm and not in the category of communications received that are required to be kept.

We think all three options are supportable; a key feature of any policy, however, must be consistency in approach. We also believe that different social media sites could lead to different outcomes on this question. On Facebook, it is fairly easy to capture all comments on a post, since it is on the firm's page (although a user could choose to delete his own post); on Twitter, that is harder to do, and we do not think the regulatory requirements mandate searches for all hashtags and @-tags directed to a firm (but firms might choose to keep direct messages sent to them).

Bottom Line. If a financial services firm's primary business purpose for using social media is to form or mobilize communities, then, we would argue that a social media policy that hews closely to the FINRA and SEC guidance would be leaving out key elements. While the FINRA and SEC guidance do touch upon certain key considerations—such as the prohibition on testimonials, the responsibility for certain third-party posts, and recordkeeping—a thoughtful policy and training program would go beyond the guidance on third-party posts to actively consider how its moderators will interact with other users. The policy would also address, most notably, the Communications Decency Act and possibly FTC limitations on deleting unfavorable posts and employee postings.

LIVE SEARCH CAPABILITY

Effective Use of Social Media. One of the key advantages social media has against "Web 1.0" is the ability to learn about events in real-time. While search engines are incredibly fast and accurate at providing links to pages on the World Wide Web regarding particular topics, they are less adept at being able to provide search results on events occurring live. In broad strokes, for a search engine to find a page, it must first catalogue a page for it to be retrieved. While that happens very quickly, it cannot match the speed of social media users who can report on events as they occur. Twitter is a particularly good platform for live search since it converts millions of users into eyewitness reporters, as users who followed during the Arab Spring revolutions or Hurricane Sandy can attest. By searching the proper topic or the appropriate hashtag, a Twitter user can follow live events as they unfold.

While the usefulness of live search may be obvious for those unable to watch sporting events live, or those trying to get information on power outages as they spread in the wake of a hurricane, the usefulness for financial services firms may be less obvious. But many financial firms have used the live search feature for business purposes. One of the most common ways firms have used social media in this way is by enhancing the interactivity of a company's quarterly earnings report. Many firms, for example, live tweet their earnings report, and industry analysts interpret and comment on the report in real time using the same hashtag.[62] While the company and industry analysts are tweeting, anyone else in the general public can perform a search of that hashtag or topic and follow along in real time and make his or her own assessment of the report, including potentially adding his or her own comment to the conversation.

One of the most common ways firms have used live search cabability is to enhance the interactivity of a company's quarterly earnings report—for example, live tweeting their earnings report, and having industry analysts interpret and comment on the report in real time using the same hashtag.

Mutual fund firms, such as Vanguard,[63] live tweet webcasts with key investment professionals, which is a way of turning the provision of market insights into events that enhance brand recognition and loyalty. While firms generally limit the number of communications via social media lest their feed be seen as "spam" by followers, providing updates on real-time events anecdotally is less likely to be seen as spam by followers, especially if it is done relatively infrequently. But the temporary spike in the number of communications increases, axiomatically, the chances of a firm's content being seen on a user's newsfeed, and that may be a valuable way to reach followers who follow a large number of other users (incidentally, those followers may be the most valuable followers upon whom to make an impression, since they have the largest network to which they can retweet or otherwise promote awareness of a firm's brand).

[62] See Dominic Jones, "Live Tweeting Becomes a Fixture of Earnings Season" (IR Web Report, Aug. 16, 2011), available at http://irwebreport.com/20110816/live-tweeting-quarterly-earnings/.

[63] See @Vanguard_Group, Tweet (Twitter, Feb. 21, 2013, 11:02 AM), available at https://twitter.com/Vanguard_Group.

Similar to the other specific, designated purposes for social media adoption by the financial services industry, this purpose needs to be leveraged appropriately for the firm to take full advantage of its benefits. Even as social media has lessened information asymmetry and may thereby reduce a client's reliance on a financial firm as its sole source for investment advice, a financial firm still has an important role to play on this newly leveled landscape. Thus, taking advantage of live search is important even for those firms that do not choose to broadcast firm events live over social media. By that, we mean that firms should be aware that a significant portion of real-time communication regarding matters of interest to firms' clients is happening in connection with live events. Firms should be aware of hashtags and trending topics[64] in their field to ensure that their addition to the conversation can be easily seen, among other comments, if firm clients opt to perform a live search for that topic.

It is important that financial firms do not allow the limitations of a social media platform—such as the 140 character limit on Twitter—to result in misleading statements.

Regulatory Concerns. The risks that arise in this area, particularly with live events such as tweeting earnings calls or webcasts, should be familiar to most financial industry professionals. First and foremost, financial firms must continue to observe their responsibility to avoid untrue statements of material fact and avoid omissions of material facts that might result in misleading statements.[65] While this might seem an easy duty to uphold, the casual and rapid nature of communication on social media may cause some professionals to take a less vigilant approach to the nature of their communication. Furthermore, it is important that financial firms do not allow the limitations of a social media platform—such as the 140-character limit on Twitter—to result in misleading statements. Similar concerns arise when considering the suitability requirements under FINRA rules. Thus, if a firm chooses to utilize social media as a means of enabling live search regarding the firm, or to enable employees to comment on live events in real time, the significant focus in a firm's compliance program should be on topics relating to the types of permissible communications. As discussed earlier, FINRA and the SEC have offered guidance on supervision of employees as well. Given the inherent fast-paced nature of live search, we believe the primary method of supervision must be through extensive training of the individuals who will be communicating on the firm's behalf.

Regulation FD. Another key area of concern when utilizing social media for live search arises from Regulation FD, which prohibits public companies from making selective disclosure of material, non-public information to select individuals before such information is made available to the general public.[66] Recently, the SEC offered guidance on how firms can manage their responsibility under Regulation FD in the social media age.[67] The guidance stemmed largely from the investigation of Netflix and its CEO, Reed Hastings, who found himself in hot water over a Facebook post that proclaimed Netflix subscribers had watched one billon hours of video during a single month.[68] While Mr. Hastings' post existed in the public domain, including being directly posted to his over 200,000 followers, the SEC still pursued an investigation of Mr. Hastings and Netflix for allegedly violating the selective disclosure rule.[69] The SEC ultimately decided not to pursue an enforcement action and instead established that sharing information in a social media post can in certain circumstances be akin to publishing it on a corporate website, as long as investors are alerted in advance that such information will be shared using particular social media outlets.[70] In light of this recent guidance, firms should consider including a statement in their press releases and other public reports that specifically refers to the company's social media accounts as a source for important information about the firm. It is also critical for any firm that allows its employees to use social media on a real-time basis to have a clear policy regarding the disclosure

[64] On Twitter, if a particular topic, hashtag, or user is being tweeted about by a large number of users at the same time, then it is said to be "trending."

[65] See, e.g., 17 CFR § 240.10b-5 (2012).

[66] 17 CFR pt. 243 (2012). Mutual fund firms should also be aware of rules regarding disclosure of portfolio holdings. See *Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings*, SEC Release No. 33-8408 (May 28, 2004), available at http://www.sec.gov/rules/final/33-8408.htm#text.

[67] SEC Release No. 69279, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Netflix, Inc., and Reed Hastings*, April 2, 2013.

[68] See Michael J. De La Merced, "S.E.C. Sets Rules for Disclosures Using Social Media" (N.Y. Times DealBook, Apr. 3, 2013, 9:53 PM), available at http://dealbook.nytimes.com/2013/04/02/s-e-c-clears-social-media-for-corporate-announcements/.

[69] Id.

[70] SEC Release No. 69279, supra note 67.

of non-public information; ordinarily, an individual employee account (as opposed to an account in the name of the company) would likely not be the avenue for such communications under the SEC's guidance on this topic. Firms should also be aware that the New York Stock Exchange may have different requirements for the dissemination of certain types of information, so a release of information on social media that complies with the SEC guidance may require simultaneous notification of wire services and/or the filing of a Form 8-K.

Securities Offerings. Another area of concern relates to the regulations related to securities offerings, whether private placements or public offerings. Firms should carefully craft policies so that the parameters of the Regulation D exemption under the Securities Act of 1933 for private placements or the "gun-jumping" rules for public offerings, whichever are applicable to the situation, are not triggered.[71] Similarly, when there is an ongoing proxy solicitation in effect for a firm or one of its funds, the firm should be careful not to trigger any violations of Regulation 14A under the Exchange Act (which generally requires that solicitations not be made unless each person solicited concurrently is furnished or has previously been furnished with the relevant proxy statement).[72]

Bottom Line. Thus, when a financial services firm seeks to utilize the live search functionality of social media, rather than focusing on the existing guidance, firms should concentrate their efforts on training key individuals regarding the types of permissible statements under relevant anti-fraud rules. In addition, policies should cover areas that are not addressed at all in the existing guidance, including the private placement/gun-jumping rules and proxy solicitation rules. Of course, as noted above, certain issues remain, such as recordkeeping, but the key areas of compliance concern differ based on the business purpose underlying the use of social media.

EFFICIENT AND COST-EFFECTIVE CUSTOMER SERVICE

Effective Use of Social Media. In the past few years, social media platforms have been increasingly utilized as valuable customer service tools. In some instances, such as the outrage not too long ago over the big banks' proposed ATM fees, social media has been used spontaneously and without any encouragement by the financial services companies. This firestorm clearly caught the attention of the banks' customer service departments as all of the banks were ultimately forced to back down from their proposed fees.[73] In contrast, many financial firms have proactively adopted Facebook profiles or Twitter user names that are to be used specifically by customers for complaints and questions. Today, since most people have access to the internet via either their computers or their mobile devices, the speed and directness of using social media to resolve a customer service issue is appealing. Indeed, for many, firing off a wall post or a tweet is much better than waiting on hold for the next available customer service representative.

Critics of this new approach to customer service argue that it does not save the customer any time because, due to the confidential nature of most financial issues, the issue is ultimately re-directed to a traditional form of customer service, such as a call center or the customer's local branch. While this may be true for many financial firms today, others have already developed innovative systems to overcome this shortcoming. For instance, Citigroup hired a software maker, LivePerson Inc., to design a program that allows customers to click on a link in the Facebook or Twitter conversation that immediately switches the conversation to a live online chat or telephone call with the same customer service agent who was addressing the customer's concerns via social media.[74]

While some financial firms may not like the idea of having customers' complaints and/or questions aired publicly for all to see, this method may actually work in their favor. As an initial matter, since the question or complaint is viewable by the public, there is a chance that other users with a similar problem may take it upon themselves to respond to the issue, if they know the answer. Furthermore, if the resolution of the issue has greater applicability (e.g., the website is down), it also allows other users to benefit from the public conversation without overloading phone centers. In addition, the firm's wall or Twitter feed may serve as an informal Frequently Asked Questions (FAQs) bulletin board, which customers can scroll through to find the answer to their questions on issues that have been previously resolved for other customers.

Financial services companies should also recognize that this public airing of grievances enables the company to publicly turn negative publicity into a

[71] 17 CFR § 230.501-.508 (2012); 15 U.S.C. § 77e (2006).

[72] 17 CFR § 240.14a-1-.14b-2.

[73] See Tara Siegel Bernard, "Bank of America Drops Plan for Debit Card Fee," N.Y Times, Nov. 2, 2011, at A1.

[74] See Suzanne Kapner, "Citi Won't Sleep on Customer Tweets," Wall St. J., Oct. 5, 2012, at C1.

positive. By providing a timely and accurate response to customer complaints via social media, a firm can publicly show that it listens to its customers and will provide needed assistance. These social media customer service outlets provide another important "touch point" between the firm and its customers and according to a financial industry insider "customer satisfaction is almost directly correlated with the number of touch points."[75]

Regulatory Concerns. In providing first-class customer service, there are important regulatory concerns that financial firms need to consider, many of which are not addressed in the existing guidance.

Privacy Issues. First, firms should remain aware of their obligations under various data privacy laws. Customers will sometimes provide, even though one might not expect it, personal identifying information (PII) via social media channels. Firms should take care not to request such personal information, and should have policies to direct conversations on to private (preferably proprietary) systems to continue conversations where PII is required to solve the problem.

If PII or other non-public personal information is transmitted to a financial services firm, then the firm must remain cognizant of its responsibilities under the Gramm-Leach-Bliley (GLB) Act,[76] which requires a financial institution to have systems in place for protecting any confidential information that it receives from customers.[77] Additionally, if the institution chooses to collect such information using social media, then certain privacy disclosure obligations are triggered, including the delivery of a privacy notice and notification of the right to opt out of any disclosure of a customer's information to third parties.[78] Since such disclosure obligations may be difficult to meet in the social media context, firms will likely want to avoid the collection of such information. Another reason to avoid collecting such information is because data breaches or other unauthorized uses of PII may result in a number of inconvenient and potentially embarrassing consequences, such as having to cooperate with law enforcement as they pursue an investigation and having to notify customers affected by such incident.[79]

Customer Complaints. Second, registered broker-dealers need to be mindful of FINRA Rule 4530(a)(1)(B), which requires a member firm to report within 30 calendar days after the firm knows or should have known that an associated person is the subject of any written customer complaint alleging theft, misappropriation of funds or securities, or forgery.[80] Member firms also must report quarterly statistical and summary information regarding such written customer complaints.[81] In addition, registered investment advisers need to follow their internal policies and procedures for handling customer complaints.[82]

Facebook posts and tweets are in a written format, so a broker-dealer firm would need to report such a complaint if that complaint is from a customer of the firm. A question arises as to whether a complaint is from a "customer," because user identification is not always possible through a social media channel. Some firms choose to include all social media complaints regardless of whether they have been able to identify an individual as a customer, while others provide that the firm will follow up with the individual in private channels to determine whether the individual is a customer. In our experience, the plurality of firms do not have any policy at all on customer complaints, which may be reasonable *unless* the firm chooses to use social media for the purpose of providing customer service.

Employee Use of Personal Devices. Another issue that may arise, regardless of the business purpose for using social media (but which is more likely to arise in the context of using social media for customer service),

[75] Kristen French, "Momentum Building for Social Media Adoption in Financial Services" (Wealth Management, Oct. 27, 2011), available at http://wealthmanagement.com/resources-amp-community/momentum-building-social-media-adoption-financial-services.

[76] See Bureau of Consumer Protection, In Brief: The Financial Privacy Requirements of the Gramm-Leach-Bliley Act (2002), available at http://business.ftc.gov/documents/bus53-brief-financial-privacy-requirements-gramm-leach-bliley-act.

[77] See id.

[78] See id.

[79] See Gina Stevens, *Data Security Breach Notification Laws*, Cong. Research Serv. (2012), available at http://www.fas.org/sgp/crs/misc/R42475.pdf.

[80] See FINRA, Reporting Requirements: FINRA Provides Additional Guidance Regarding Reporting Requirements Under Rule 4530, Regulatory Notice 11-32 (July 2011), available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123929.pdf.

[81] Id.

[82] Unlike FINRA, the SEC has not provided specific guidance on how customer complaints should be handled, but the firm's compliance manual often will have a clearly delineated procedure for investigating and resolving complaints. Also, investment adviser representatives (as well as broker-dealer representatives) must report certain customer complaints periodically on FINRA Form U4. In addition, some states require that investment advisers keep records of all customer complaints. See, e.g., Wis. Admin. Code DFI-Sec § 5.03(1)(h) (2013).

is how to handle the use of personal devices by employees for business use. In an effort to provide prompt and effective customer service, some financial services companies may allow their employees to use their personal mobile devices or computers to respond to client inquires. Both the SEC and FINRA leave it to the discretion of the individual company to decide if it wants to allow this; if it is allowed, these employees must comply with all of the applicable regulations, especially the recordkeeping rules.[83]

Since the line between personal and business communications may become blurred in some instances, we recommend as a best practice that employees be encouraged to maintain entirely separate accounts for work and personal use. If an employee is not required to maintain separate accounts and chooses to consolidate the two, then the firm must be able to retain, retrieve, and supervise all business communications, and employees should be aware that purely personal communications may be reviewed by compliance personnel. Compliance with this requirement may become more difficult as a number of states and the U.S. Congress are considering laws to protect against employers gaining access to employees' personal social media accounts.[84] As a result of this pending legislation, the line between an employee's personal accounts and business accounts may need to be hardened and more vigorously enforced, since employers may not be able to adequately supervise and retain business-related communications from an employee's personal accounts, if any such communications should occur. Additionally, the firm's social media policy should address how employees respond to business inquiries that they may receive via their personal accounts, such as requiring employees to follow-up using business email only or by responding with a pre-approved statement.

Bottom Line. If a financial services firm chooses to use social media for customer service purposes, the existing regulatory guidance leaves out some of the most important issues. While the guidance does comment on the use of personal devices and recordkeeping (two important considerations), firms that restrict their compliance review to only those issues may ignore more important considerations from a compliance and risk perspective. In this context, we believe firms should focus their compliance efforts on customer privacy and data protection, as well as having clear rules for how to consider social media communications in light of rules and practices regarding customer complaints.

CONCLUSION

Regardless of the business purpose for which a firm uses social media, the time has come for firms that have not already done so to adopt written social media policies. The prevalence of social media as a method of communication shows no signs of abating; firms cannot afford to bury their heads in the sand and state that they simply do not use social media. As a factual matter, all firms are using social media, in the sense that there are employees at every firm who use social media, many of whom no doubt identify themselves on social networks as being employed by the firm at which they work. Furthermore, firms of any substantial size are being discussed on social media in some fashion (even if it is simply a Wikipedia page), and those that choose to ignore social media may be permitting statements about themselves to go unchallenged. In the SEC guidance, the staff stressed that firms using social media must adopt and periodically review the effectiveness of their policies and procedures regarding social media use by the firm.[85] In addition, they took the position that financial services companies need to have dedicated, unique social media policies rather than relying on an overlap of policies in other areas to cover social media concerns.[86] On this point we agree with the SEC guidance.

Regardless of the business purpose for which a firm uses social media, the time has come for firms that have not already done so to adopt written social media policies.

Despite the critics and the naysayers, social media use by the financial services industry is prevalent and it will only continue to grow as the social networks continue to expand and become further entrenched in the public's online consciousness. As more and more financial firms adopt social media as a routine part of their business, it is important for the firms to remain focused on why they are using social media in the first place. By having a clear business purpose, the firms

[83] SEC Risk Alert, supra note 1; FINRA, Regulatory Notice 11-39, supra note 1; FINRA, Regulatory Notice 10-06, supra note 1.

[84] See "'Like' It or Not: Broker-Dealers and Social Media Access" (Law360, June 28, 2012, 1:32 PM), available at http://www.law360.com/articles/352725/-like-it-or-not-broker-dealers-and-social-media-access.

[85] SEC Risk Alert, supra note 1; 17 CFR § 275.206(4)-7 (2012).

[86] SEC Risk Alert, supra note 1.

will not only be more effective in their online interactions, but will also have a better understanding of the risks involved. We have identified the four major purposes for which financial services firms might use social media, and we believe this is a useful framework for considering the issues involved. That said, social media are constantly evolving, and there are other purposes for which firms can and will use social media as the platforms develop. For example, some prominent firms are using social media mentions as an early warning system of sorts to alert them to the possibility of negative press coverage regarding the firm (on the theory that social media mentions will precede regular press mentions by crucial hours in the face of a possible crisis). Thus, we are not saying that these are the only business purposes for social media. Rather, we hope that by framing the issue in this fashion, firms will be better able to understand the power of social media, and better able to address the actual risks they face, which in some cases go beyond those identified by the regulators. We reiterate an earlier point—the lack of regulatory certainty should not lead to paralysis. We hope firms will continue to find new, innovative ways to connect with their customers and that legal and compliance departments will not be a roadblock to that progress. ■

2013 Securities Law Developments Conference

Twice as Busy? New Compliance Obligations for Fund CPOs

December 11, 2013

Panelists

Ruth S. Epstein
Stradley Ronon Stevens & Young, LLP

J. Stephen King, Jr.
PIMCO LLC

Tara Tilbury
Ameriprise Financial, Inc.

Carol A. Wooding
National Futures Association

Rachel H. Graham, Moderator
Investment Company Institute

Panel Agenda

- Issues for Rule 4.5 Compliant Funds
- Fund CPOs: Meet the NFA, Your New Frontline Regulator
- New Compliance Obligations for Fund CPOs
- Still to Come . . . ?

Issues for Rule 4.5 Compliant Funds

- Ongoing monitoring of trading thresholds and marketing efforts
  - Practical issues for subadvised funds
- Annual reaffirmation
  - Filings by fund/adviser, subadviser
- Are you managing a fund of funds?
  - Current no-action relief
  - Future guidance?

Fund CPOs: Meet the NFA, Your New Frontline Regulator

- Interaction between NFA and CFTC
- CPO registration
- NFA's approach to oversight
- Examinations – what you can expect
- Seeking regulatory guidance or relief

New Compliance Obligations for Fund CPOs

- Scope – funds that are commodity pools
- Degree of harmonization as between SEC and CFTC requirements
  - Considerable ☺: disclosure, shareholder reports
  - Some 😐: recordkeeping
  - None ☹: periodic reporting to regulators

New Compliance Obligations for Fund CPOs (cont'd)

- What if your fund has a controlled foreign corporation (CFC)?
- What if your fund has one or more subadvisers?
- And there's more: NFA requirements for CPOs

New Compliance Obligations for Fund CPOs (cont'd)

- Disclosure
  - File claim of exemption with NFA
  - Comply with federal securities laws, SEC rules and SEC/staff guidance
  - Include related performance disclosure (only if fund in operation for less than 3 years)
    - Caution – more to this than may meet the eye
  - Expand Rule 481 legend to include CFTC

New Compliance Obligations for Fund CPOs (cont'd)

- Shareholder Reports
  - File claim of exemption with NFA
  - Make current NAV available to shareholders
  - Disclose to shareholders how they can access the current NAV

New Compliance Obligations for Fund CPOs (cont'd)

- Shareholder Reports (cont'd)
  - Provide shareholders with SEC-compliant annual and semiannual reports, and file Form N-CSR
  - File fund's audited annual financial statements with NFA within 90 days after fund's fiscal year end*

    *Note – awaiting CFTC confirmation

New Compliance Obligations for Fund CPOs (cont'd)

- Recordkeeping
  - To maintain records with a third party:
    - Use a specified entity—adminstrator, distributor or custodian (or bank/B-D acting in similar capacity)
    - File statement with NFA indicating what records will be kept where and by whom
      - Make certain representations
      - Include statements from each recordkeeper

New Compliance Obligations for Fund CPOs (cont'd)

- To maintain records with a third party (cont'd):
  - Disclose location of books and records in fund registration statement*

    *Note – awaiting CFTC confirmation

- Maintain shareholder records with transfer agent; list of "relevant intermediaries" ok for shares held in omnibus accounts or by intermediaries

- No harmonization of substantive recordkeeping requirements

New Compliance Obligations for Fund CPOs (cont'd)

- Periodic Reporting to Regulators
  - CFTC Form CPO-PQR
    - Schedule A – basic information about CPO, each fund, and fund service providers
    - Schedule B – schedule of investments for each fund, and information on fund's creditors, counterparties, borrowings, and clearing mechanisms
    - Schedule C – aggregate information about funds managed by the CPO plus more detailed information on each "large pool" (*i.e.*, $500 million in assets)

New Compliance Obligations for Fund CPOs (cont'd)

- CFTC Form CPO-PQR (cont'd)
  - Level and frequency of reporting is based on AUM
  - What is interaction with Form PF?
  - FAQ submitted by ICI and IAA
  - Until guidance is issued, document "reasonable" assumptions and any discussions with CFTC or NFA

New Compliance Obligations for Fund CPOs (cont'd)

- Periodic Reporting to Regulators (cont'd)
  - NFA Form PQR
    - All CPOs – quarterly filing of Schedule A plus itemized schedule of investments
    - Good news! Fund CPOs typically will report quarterly on CFTC Form CPO-PQR, which NFA will accept for this purpose
  - First filing(s) for fund CPOs covers the reporting period ending December 31, 2013

New Compliance Obligations for Fund CPOs (cont'd)

- What if your fund has a CFC?
  - CFTC considers CFC to be a separate pool
  - Harmonization rules do not extend to CFC, but relief is available
  - No separate disclosure document for CFC if fund prospectus includes a discussion of (1) the fund's investment in the CFC and (2) principal risks associated with that investment

New Compliance Obligations for Fund CPOs (cont'd)

- What if your fund has a CFC (cont'd)
  - If fund and CFC have consolidated financials:*
    - File claim with CFTC for Rule 4.22 relief per No-Action Letter 13-51
    - Notify NFA before Dec. 31, 2013, following instructions in Notice to Members I-13-36
    - Submit consolidated financials to NFA (per slide 9)

    * Note – awaiting CFTC confirmation that no separate identification of CFC holdings is required

New Compliance Obligations for Fund CPOs (cont'd)

- What if your fund has a CFC (cont'd)
  - If CFC is wholly owned by the fund, no separate reporting on Form CPO-PQR if:
    - File claim with CFTC for Rule 4.27 relief per No-Action Letter 13-51
    - Notify NFA before Dec. 31, 2013, following instructions in Notice to Members I-13-36
    - Consolidate CFC's data with that of fund when reporting on Form CPO-PQR

New Compliance Obligations for Fund CPOs (cont'd)

- What if your fund has one or more subadvisers?
  - CTA registration
  - Disclosure and recordkeeping requirements
    - Harmonization rules do not extend to CTAs
    - What about Rule 4.7 exemption?

New Compliance Obligations for Fund CPOs (cont'd)

- What if your fund has one or more subadvisers (cont'd)
  - Periodic reporting to regulators
    - CFTC Form CTA-PR: annual filing
    - NFA Form CTA-PR: quarterly filing

New Compliance Obligations for Fund CPOs (cont'd)

- NFA Requirements for CPOs
  - Ethics training
  - Business continuity and disaster recovery plan
  - Annual self-examination
  - Annual questionnaire
  - *Note – relief for fund CPOs from Rule 2-45 prohibition on certain affiliated transactions

Still to Come . . . ?

- From CFTC:
  - Fund of funds guidance
  - Form CPO-PQR filing guidance
  - Relief from Rule 4.20 prohibition on certain affiliated transactions
  - Further recordkeeping relief

Still to Come . . . ? (cont'd)

- From NFA:
  - Review of SEC and FINRA advertising rules
  - Finalization of Bylaw 1101 guidance
  - NFA rule changes to reflect harmonized regime for fund CPOs

Commodity Pool Operator Regulation of Registered Funds and Their Advisers
The New Age of Dual Regulation

Ruth S. Epstein
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Molly O'Brien
Stradley Ronon Stevens & Young, LLP
December 2, 2013

2013 Securities Law Developments Conference
December 11, 2013
Washington, D.C.

TABLE OF CONTENTS

Page

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The New Age of Dual Regulation

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I. Introduction and Overview

A. Entrance of the CFTC onto the Registered Fund Regulatory Scene

In early 2012, the Commodity Futures Trading Commission ("CFTC") took final action that brought the registered fund industry into the CFTC's commodity pool operator regulatory scheme.

1. Amendments to Rule 4.5

On February 9, 2012, the CFTC adopted amendments to CFTC Rule 4.5 that eliminated the blanket exclusion from the definition of commodity pool operator ("CPO") for investment companies registered under the Investment Company Act of 1940 (the "1940 Act") and their investment advisers, which Rule 4.5 had provided since 2003.[1] Under the Rule as amended, only 1940 Act registered funds ("RICs") that meet both a "*de minimis*" trading test and a marketing test with respect to their transactions in "commodity interests," and the advisers and operators of those funds, will qualify for the CPO exclusion.[2] As of December 31, 2012, advisers to RICs that do not meet these tests have been required to register with the CFTC as CPOs and to become members of the National Futures Association ("NFA").[3]

2. Suspension of CPO Regulation Pending Adoption of Final Harmonization Rules

On the same day, the CFTC proposed rules intended to "harmonize" the CFTC's CPO disclosure, shareholder reporting, and recordkeeping requirements applicable to registered

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[1] *Commodity Pool Operators and Commodity Trading Advisors: Compliance Obligations*, 77 FR 11,252 (Feb. 24, 2012) ("Rule 4.5 Amendment Release"). The amendments to Rule 4.5 reinstated trading and marketing tests similar to those that Rule 4.5 had imposed when it was adopted in 1985, but which the CFTC had eliminated in 2003. *Additional Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisers; Past Performance Issues*, 68 FR 47,221 (Aug. 8, 2003).

[2] When it amended Rule 4.5, the CFTC also rescinded a rule that had provided a blanket exemption (without trading or marketing restrictions) from CPO registration for sponsors of certain private funds (prior Rule 4.13(a)(4)). Sponsors of private funds that adhere to trading and marketing restrictions similar to those in amended Rule 4.5 may still claim an exemption from CPO registration under Rule 4.13(a)(3), which was adopted in 2003, but was little used while Rule 4.13(a)(4) was available.

[3] The CFTC has delegated the registration function to the National Futures Association, which is the self-regulatory organization for futures industry participants.

investment advisers ("RIAs") and the RICs they advise with the comprehensive regulation to which RIAs and RICs are already subject under the federal securities laws (the "Harmonization Proposal").[4] While advisers to RICs that could no longer qualify for the Rule 4.5 exclusion, as amended, were required to register as CPOs by December 31, 2012, the CFTC suspended substantive regulation of these advisers ("RIC CPOs") and the RICs that triggered the CPO registration requirement ("CPO RICs") until after adoption of final harmonization rules.

3. Final Harmonization and Post-Harmonization Rules

After a long period of suspense, the CFTC issued final harmonization rules on August 13, 2013 (the "Harmonization Rules").[5] Generally, the Harmonization Rules adopt an approach of "substituted compliance" for the disclosure and shareholder reporting requirements applicable to RIC CPOs and CPO RICs. That is, compliance with the disclosure and shareholder reporting requirements under the federal securities laws and Securities and Exchange Commission ("SEC") rules will satisfy the CFTC's rules in these areas, subject to certain additional disclosure, filing, and other requirements. In addition to imposing new requirements for compliance with the Harmonization Rules, the CFTC's adoption of these Rules has now triggered the obligation of RIC CPOs and CPO RICs to comply with the CPO rules that were not harmonized, but were suspended for these advisers and funds pending adoption of the rules (the "Post-Harmonization Rules"). As of the compliance dates established for these various requirements, RIC CPOs and CPO RICs are subject to substantial new regulatory requirements.

4. The SEC Division of Investment Management's Derivatives Guidance Update

On the same day that the CFTC issued the Harmonization Rules, the Division of Investment Management (the "Division") of the SEC issued guidance on the disclosure and compliance obligations of RICs that engage in derivatives trading, and their boards of directors (the "IM Guidance Update").[6] The IM Guidance Update may be viewed as part of the body of securities law regulation with which RIC CPOs and CPO RICs must comply in order to satisfy the CFTC's substituted compliance requirement.

B. Transformation of the Regulatory Landscape

The amendments to Rule 4.5, the Harmonization Rules, and the Post-Harmonization Rules have had a fundamental impact on the fund industry.

1. Impact of Amended Rule 4.5

Most RICs meet the new Rule 4.5 tests and continue to qualify for the CPO exclusion. These RICs, and their advisers with respect to them, are not directly affected by the Harmonization or Post-Harmonization Rules. Nonetheless, fund organizations now must implement programs to ensure compliance with the tests and monitor compliance on an ongoing basis. In addition, the product development process for new RICs now involves consideration of whether the new RIC will

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[4] *Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators*, 77 FR 11,345 (Feb. 24, 2012) (the "Harmonization Proposal Release").

[5] *Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators*, 78 FR 52,308 (Aug. 22, 2013) (the "Harmonization Release").

[6] IM Guidance Update, No. 2013-05 (Aug. 2013), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf.

be inside or outside of the CPO exclusion. Finally, one important aspect of the new tests – their impact on funds of funds – remains uncertain pending further guidance from the CFTC staff. Depending on the nature of the guidance, the number of RICs and advisers that can no longer rely on Rule 4.5 could increase dramatically.

2. Impact of the Harmonization and Post-Harmonization Rules

RIC CPOs and CPO RICs are now fully engaged in the substantial task of complying with their new responsibilities under the Harmonization and Post-Harmonization Rules. Despite the CFTC's substituted compliance approach for disclosure and shareholder reporting, these new responsibilities are considerable. Moreover, lack of clarity of some of the new requirements, as well as in the applicable compliance dates, has required the expenditure of additional time, effort, and resources.[7]

C. Plan of the Outline

This Outline is designed to help RICs and their advisers navigate the regulatory landscape in the new age of dual regulation. To that end, the Outline includes sections on the following topics:

- the amended Rule 4.5 requirements (Part IV);
- the registration and NFA membership application process for advisers to RICs that do not claim the Rule 4.5 exclusion and must register as RIC CPOs (Part V);
- the Harmonization and Post-Harmonization Rules for RIC CPOs and CPO RICs (Parts VI and VII); and
- an overview of the NFA rules for CPO members (Part VIII).

To put the new landscape in context, the Outline also includes two introductory sections, a brief account of the history leading up to the Harmonization Rules following the Rule 4.5 amendments (Part II) and an overview of the statutory scheme and relevant definitions (Part III).

II. A Brief History of the Harmonization Rules – The Road to Substituted Compliance

A. The Specter of Duplicative, Burdensome, and Inconsistent Regulation

The CFTC's amendment of Rule 4.5 in 2012 had been heatedly opposed by the fund industry. The amendments reflected a change in course from the CFTC's decision in 2003 to exclude "otherwise regulated" entities, including RICs and their advisers, from CPO regulation. At that time, the CFTC had removed from Rule 4.5 the trading and marketing tests that previously had been conditions of the exclusion for all of the entities covered, based in part on the regulation of the excluded entities under other comprehensive regulatory schemes.

The Rule 4.5 amendments potentially subjected a significant number of RICs and their advisers to dual – and sometimes dueling – regulation by two different federal regulators under two

[7] The U.S. government shutdown, which commenced shortly after the Harmonization Rules were published and during the period when the industry was digesting them, further impeded the ability to obtain clarification on compliance dates and other issues.

different regulatory regimes.[8] Understandably, this prospect met with considerable concern on the part of the fund and adviser industry.

The CFTC intended the Harmonization Proposal, which accompanied adoption of the Rule 4.5 amendments, to allay these concerns by fashioning rules that would reduce regulatory duplication and inconsistency.[9] The CFTC's initial approach to harmonization was to address specific rule provisions that appeared to conflict or overlap with SEC requirements, but left much of the CFTC's CPO regulatory regime intact, including CFTC-specific disclosure and shareholder reporting requirements.

B. Industry Concerns and Reaction

Despite the CFTC's expressed goal of eliminating duplicative and inconsistent regulation, it was widely agreed among funds and advisers that the rules as presented in the Harmonization Proposal would not achieve this goal, and that CFTC regulation of funds and advisers as proposed, on top of SEC regulation, would still be at best burdensome, and at worst conflicting and counterproductive, relative to any potential benefits.

Of particular concern was the adverse impact the Proposal would have on RIC prospectuses, and the potential for undermining the effective, investor-friendly disclosure approach the SEC and the industry had developed over decades, specifically for RIC investors. In addition, the prospect of subjecting RIC registration statements to the NFA for review and acceptance, as required for CPO disclosure documents, was viewed as unworkable given the SEC filing and review process and the automatic effectiveness provisions for post-effective updates established by SEC rules.

The response to the Rule 4.5 amendments and the Harmonization Proposal was twofold.

1. Industry Comments

A broad range of fund organizations, advisers, industry groups, and other spokespersons for the industry participated actively in the comment process for the Harmonization Proposal, and submitted comprehensive and compelling materials urging the CFTC to adopt a more truly "harmonized" approach. The centerpiece of these submissions was a description of the comprehensiveness and effectiveness of existing SEC fund and adviser registration, which, it was urged, was designed for and effectively accomplishes the same regulatory goals the CFTC was seeking.

The tenor of the industry's reaction is well captured in the following excerpts from two industry comment letters:

> The Commission's stated goal of harmonizing CPO requirements with [SEC] requirements applicable to RICs is one which we strongly endorse. However, we believe that the Proposed Rules fall far short of achieving this objective, with the result that RICs will be subject to CFTC regulatory requirements that conflict with their existing obligations under the federal securities laws; mandate additional,

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[8] As explained below in Section III, because the definition of commodity interests had been expanded to include swaps as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the CFTC's CPO jurisdiction in 2012 covered a much broader range of activities and pools than in 2003.

[9] Harmonization Proposal Release, *supra* note 4.

unnecessary and potentially confusing forms of disclosure and reporting to investors; and demand costly systems and infrastructure changes. As we demonstrate below, the additional regulatory overlay imposed by the CPO requirements would provide no identifiable improvement to the already comprehensive investor protections provided by the Investment Company Act and other federal securities laws applicable to RICs. In fact, the putative beneficiaries of these requirements – investors in the RICs to be regulated under the newly applicable CPO requirements – will in fact be adversely impacted, as the increased costs imposed upon RICs are passed on to the millions of American households for whom RICs have long served as the investment vehicle of choice.[10]

* * *

Sadly, this Proposal fails to deliver on the Commission's stated intention. Indeed, to call it a "harmonization" is a gross mischaracterization. The Proposal does very little to address the "duplicative, inconsistent, and possibly conflicting disclosure and reporting requirements" cited in the Proposal. To the contrary, the Proposal, if adopted in its current form, would do great harm to fund investors by essentially nullifying the SEC's efforts over the past 30 years to make fund disclosure clear, concise, and therefore more useful to investors. The Proposal would also impose extremely burdensome, costly, and unnecessary reporting requirements on funds and their advisers.[11]

2. The Lawsuit Challenging the Rule 4.5 Amendments

In addition to submitting comprehensive comments on the Harmonization Proposal, on April 17, 2012, the Investment Company Institute (the "ICI"), together with the U.S. Chamber of Commerce ("the Chamber"), filed suit against the CFTC in the U.S. District Court for the District of Columbia challenging the legality of amended Rule 4.5 and seeking injunctive relief to prevent the CFTC from implementing the Rule as amended.[12]

The complaint alleged that the CFTC's action was arbitrary and capricious and in violation of the Administrative Procedure Act, and that the CFTC had adopted the amendments without satisfying its obligation under the Commodity Exchange Act ("the "CEA") to weigh the costs or benefits of the Rule. Among other things, the complaint alleged that (1) amended Rule 4.5 would impose unnecessary, overlapping, and burdensome regulations on registered funds, their advisers, and, ultimately, fund shareholders; (2) the CFTC had failed to explain the reversal of its 2003 decision that additional CFTC regulation of investment companies was unnecessary and burdensome, and would impair liquidity

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[10] *See* Comment letter from the Asset Management Group (AMG) of the Securities Industry and Financial Markets Association (SIFMA), Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators (Apr. 24, 2012) (footnotes omitted), *available at* http://www.sifma.org/issues/item/aspx?id=8589938476.

[11] *See* Comment letter from the ICI, Regulation 4.5 Harmonization (Apr. 24, 2012), *available at* http://www.ici.org/pdf/26083.pdf.

[12] *ICI & U.S. Chamber of Commerce v. CFTC*, Complaint, No. 1:12-cv-00612 (D.D.C. Apr. 17, 2012), *available at* http://www.ici.org/pdf/12_commod_inv_complaint.pdf.

in the derivatives markets; and (3) the CFTC had failed to articulate any discernible benefits from the Rule above and beyond those already provided to investors through existing regulation.

On December 12, 2012 (less than three weeks before the registration deadline for RIC CPOs), the District Court ruled in favor of the CFTC and upheld the amendment to Rule 4.5 as a rational exercise of the CFTC's authority.[13] The District Court found that the link between derivatives trading and the 2008 financial crisis provided a rational basis for the CFTC to reinstate the trading threshold and marketing restrictions removed in 2003, and that amended Rule 4.5 effectuated the mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") "to provide more transparency and regulatory oversight of derivatives trading generally," which supplied a reasoned justification for the amendments.

The ICI and Chamber filed an appeal with the U.S. Court of Appeals for the District of Columbia Circuit on December 27, 2012.[14] The Court of Appeals affirmed the District Court's ruling for the CFTC on June 25, 2013, finding that the CFTC's evaluation of the amended Rule's costs and benefits was not arbitrary or capricious.[15] Among other things, the Court concluded that changed circumstances, such as increased trading in derivatives and lack of market transparency, provided sufficient justification for the CFTC's change in position from its 2003 rulemaking. As a general matter, the Court's decision appeared to reflect the judgment that the costs and benefits of the CFTC's expanded regulation of RICs and their advisers could not be fully assessed until the CFTC had finalized the Harmonization Proposal.[16]

3. Industry and SEC Staff Meetings with the CFTC Staff

During the course of the lawsuit and after its conclusion, members of the industry met with the CFTC to educate the staff about the fund industry and existing regulation and to further explain to the staff why dual regulation would be counterproductive. At the same time, there were reports that the CFTC and SEC staffs were working together to confer on the Harmonization Proposal. Starting in the spring of 2013, representatives of the CFTC staff appearing at industry conferences made statements to the effect that the staff was working on a "true" harmonization approach that would defer more broadly to SEC regulation and that would be more favorably received by the fund industry than the original Harmonization Proposal. The final Harmonization Rules, which were indeed a significant improvement from the proposal, in particular as they leave RIC prospectus disclosure and the SEC registration review process intact, are discussed in Part VI.

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[13] *ICI v. CFTC*, Memorandum Opinion, No. 12-00612 (BAH) (D.D.C. Dec. 12, 2012), *available at* http://www.ici.org/pdf/26756.pdf.

[14] *ICI v. CFTC*, Notice of Appeal, No. 1:12-cv-00612 (BAH) (D.C. Cir. Dec. 27, 2012), *available at* http://www.ici.org/pdf/12_commod_inv_noticeofappeal.pdf.

[15] *ICI v. CFTC*, No. 12-5413 (D.C. Cir. June 25, 2013), *available at* http://www.cadc.uscourts.gov/internet/opinions.nsf/1CEC149BDA2443D285257B95004EB0B8/$file/12-5413-1443082.pdf.

[16] *See ICI, Chamber Respond to D.C. Circuit Decision*, Press Release (June 25, 2013), *available at* http://www.ici.org/cftc_challenge/appeal13_news_cftc.

III. CPO Registration Requirement, Definitions

A. Registration Requirement

Section 4m(1) of the Commodity Exchange Act ("CEA") provides that it shall be unlawful for any CPO, unless registered as such under the CEA, to make use of the mails or any means or instrumentality of interstate commerce in connection with its business as a CPO, unless an exemption is available.

B. Definition of "Commodity Pool Operator"

Section 1a(11) of the CEA defines a "commodity pool operator" as any person (i) engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests, including any commodity for future delivery, security futures product, or swap; agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i) [retail forex and other retail transactions];[17] or commodity options.[18] or (ii) who is registered with the CFTC as a CPO.

C. Definition of "Commodity Pool"

1. New Statutory Definition

Section 1a(10) of the CEA, added by the Dodd-Frank Act, defines a "commodity pool" as any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests, including the commodity interests listed in the definition of commodity pool operator in Section 1a(11) of the CEA, set forth above.

2. Dodd-Frank Addition of Swaps

Prior to the Dodd-Frank Act, the term commodity pool had been defined by CFTC Rule 4.10(d), but not in the CEA.[19] The Dodd-Frank Act amended the CEA to add a definition of the term commodity pool. The Dodd-Frank Act statutory definition reflects an expansion of the term commodity pool, most importantly to include swaps as commodity interests.

3. The "One Swap" Interpretation – "Inadvertent Commodity Pools"

The CFTC takes a broad view of the term "commodity pool," and has both declined to set a specific percentage as a threshold over which an entity would be considered a commodity pool and rejected the suggestion that the definition should apply only to funds whose "principal purpose" is the trading of commodity interests.[20] In the Rule 4.5 Amendment Release, the

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[17] Retail forex and other retail transactions are transactions with persons that are not "eligible contract participants" as defined in Section 1a(18) of the CEA and CFTC Rule 1.3(m).

[18] Commodity interests identified in Section 1a(10) also include leverage transactions authorized under Section 19 of the CEA, but these instruments are not currently in common use.

[19] CFTC Rule 4.10(d), which defines the term "commodity pool," has been amended to conform to the Dodd-Frank Act definition.

[20] *See, e.g.*, CFTC Letter No. 12-13 (Oct. 11, 2012).

CFTC stated that, "any swaps activities undertaken by a CPO would result in that entity being required to register because there would be no de minimis exclusion for such activity. As a result, one swap contract would be enough to trigger the registration requirement."[21] If applied literally, this "one swap" interpretation of the term "commodity pool" would make commodity pools of many types of financing and other vehicles that are not commonly thought of as commodity pools, or thought to be appropriate subjects of the CFTC's CPO regulation ("inadvertent commodity pools"). For this reason, the CFTC staff has issued a number of no-action letters clarifying that certain types of inadvertent commodity pools (*e.g.*, certain securitization vehicles and equity real estate investment companies ("REITs")) will not be considered commodity pools, subject to certain conditions, and other pooled vehicles, such as mortgage REITs, will not trigger a CPO registration requirement for their operators.[22]

4. Implications for Funds of Funds

The CFTC's broad interpretation of the term commodity pool also has significant implications for RICs that invest in REITs, securitizations, and other inadvertent commodity pools. In the Rule 4.5 Amendment Release, the CFTC stated that a fund that invests in a commodity pool is itself a commodity pool. Accordingly, a RIC that invests in inadvertent commodity pools must consider these investments in determining whether the RIC is a commodity pool and whether it meets the Rule 4.5 trading and marketing tests (as further discussed below in Part IV).

5. Controlled Foreign Corporations

Some RICs that trade in commodity interests do so through a wholly-owned foreign corporation known as a controlled foreign corporation or "CFC." Historically, sponsors of RICs that use CFCs have not viewed the CFC as a separate entity, partly because the sole participant in the CFC is the RIC. However, the CFTC, in adopting the amendments to Rule 4.5, made it clear that a CFC should be treated as a separate entity for CPO registration purposes, and that the CPO of a CFC must register as such unless a separate exemption applicable to the CFC is available.[23]

IV. Rule 4.5 – Exclusion from the CPO Definition for Certain RICs and Other "Otherwise Regulated Persons"

A. Overview of Rule 4.5

Rule 4.5 excludes certain "otherwise regulated persons," together with their principals or employees, from the definition of CPO with respect to the operation of certain "qualifying entities," subject to the requirements of the Rule. Among other types of regulated entities, Rule 4.5, by its terms, excludes a RIC, with respect to the operation of a RIC as the qualifying entity.

Prior to the 2012 amendments, Rule 4.5 provided a blanket exclusion from the CPO definition for RICs, subject only to a one-time notice filing with the NFA in order to claim the exclusion

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[21] Rule 4.5 Amendment Release, 77 FR at 11,258.

[22] *See, e.g.*, CFTC Letter No. 12-13 (Oct. 11, 2012) (equity REITs); CFTC Letter No. 12-14 (Oct. 11, 2012) (securitization vehicles). In addition, the CFTC staff has provided no-action relief from CPO registration for operators of certain other types of vehicles, subject to filing a claim for such relief. *See, e.g.*, CFTC Letter No. 12-44 (Dec. 7, 2012) (mortgage REITs).

[23] *See* Rule 4.5 Amendment Release, 77 FR at 11,260 ("Therefore, the Commission does not oppose the use of CFCs for trading in commodity interests by registered investment companies, but such CFCs will be required to have their CPOs register with the Commission unless they may claim exemption or exclusion therefrom on their own merits.").

and a disclosure requirement. Under Rule 4.5 as amended, RICs (and their advisers) qualify for the CPO exclusion only if the RIC meets both the trading and marketing tests described below. Amended Rule 4.5 also requires an annual filing with the NFA affirming continued compliance with the tests, and prompt amendment of the filing (within 15 days) if the representations become inaccurate. The Rule 4.5 exclusion terminates if the representations (including representations of compliance with the trading and marketing tests) become inaccurate. Rule 4.5 also requires the person relying on the exclusion to disclose such reliance to investors and to submit to special calls for information.

Rule 4.5 also provides an exclusion for other categories of "otherwise regulated persons," including state regulated insurance companies with respect to insulated separate accounts; banks and other depository institutions with respect to fiduciary accounts for which they have investment authority; and ERISA fiduciaries with respect to pension plans. Unlike RICs, the other entities eligible for the Rule 4.5 exclusion are not subject to the trading and marketing tests, although, with the exception of certain pension and other plans, they must comply with the filing, disclosure, and "special call" provisions of the Rule.[24]

B. Who is the Excluded RIC CPO?

Rule 4.5 refers to the RIC itself as the entity eligible for the CPO exclusion, and historically the RIC (the trust or corporation for a multi-series RIC) has filed the claim of exclusion, with respect to the RIC (or series) as the qualifying entity. However, the CFTC has stated that, for a RIC that does not meet the trading and marketing tests, the appropriate person to register as the RIC's CPO is the RIC's investment adviser.[25] For RICs that do meet the tests and continue to claim the exclusion ("Rule 4.5 RICs"), either the RIC, the adviser to the RIC, or both may claim the exclusion (see discussion below under "Filing Requirements, Recordkeeping, and Ongoing Compliance").

C. The Trading and Marketing Tests

Under Rule 4.5, in order to claim the exclusion, a RIC must both:

(i) engage in no more than a *de minimis* amount of trading in "commodity interests," measured by either of two threshold calculations set forth in the rules; and

(ii) not be marketed to the public as a commodity pool or otherwise as a vehicle for trading in the commodity interest markets.

D. The Trading Test

1. Two Alternative Calculations

To satisfy the trading test, a RIC must engage in no more than a *de minimis* amount of trading in commodity interests. This test can be met in either of two ways:

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[24] Plans identified in Rule 4.5(a)(4) are "automatically" excluded from the CPO definition, without the need to claim an exclusion, make a filing, or provide any disclosure. These automatically excluded plans include (i) noncontributory plans; (ii) contributory defined benefit plans, as long as no employee contributions are used as margin or premiums for futures or commodity options; (iii) governmental plans; (iv) employee welfare benefit plans subject to the ERISA fiduciary responsibility requirements; and (v) church plans as to which the required election has been made.

[25] *See* Rule 4.5 Amendment Release, 77 FR at 11,259.

The five percent margin test. Aggregate initial margin and premiums paid to establish positions in commodity interests do not exceed five percent of the liquidation value of the RIC's portfolio after taking into account unrealized profits and unrealized losses on any such contracts entered into by the RIC (in the case of an option that is in the money at the time of purchase, the "in-the-money amount" may be excluded in computing the five percent);

The 100 percent net notional value test. Aggregate net notional value of the RIC's commodity interest positions, determined at the time the most recent position was established, does not exceed 100 percent of the liquidation value of the RIC's portfolio after taking into account unrealized profits and unrealized losses on any such positions entered into by the RIC.

2. Definition of "Commodity Interests" for Rule 4.5

For purposes of Rule 4.5, the term "commodity interests" includes all futures contracts (including security and financial futures and futures traded on a foreign exchange), commodity options (including options on futures), and swaps.[26] The term "swaps," in turn, includes a broad range of instruments defined by the CEA and CFTC rules, but excludes "security-based swaps."[27] The term "swaps" also excludes foreign exchange forwards and foreign exchange swaps that are "deliverable" (where the agreement is to exchange the actual currencies at a specified future date, at a rate specified in the agreement), but does not exclude "non deliverable" foreign exchange forwards and swaps (where the agreement is to settle in cash).[28]

As noted above, swaps were added to the definition of commodity interests by the Dodd-Frank Act. Historically, the term commodity interests had referred to futures contracts, options on futures contracts, and certain other similar derivative instruments. The expansion of the term commodity interests to include swaps was effective on October 12, 2012, the effective date of joint rules defining the term adopted by the CFTC and SEC.[29] The inclusion of swaps as commodity interests significantly expanded the universe of RICs that are considered commodity pools, for which either the Rule 4.5 exclusion must be claimed or the adviser must register as a CPO.[30]

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[26] Rule 4.5 does not use the term "commodity interests," but rather specifically states three categories of instruments – commodity futures, commodity options contracts, and swaps – to which the trading and marketing restrictions will apply.

[27] Technically, a "security-based swap" is not a swap, under the CEA or CFTC rules. A security-based swap is an instrument in the nature of a swap based on a single security or a narrow-based security index.

[28] *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act,* 77 FR 69,694 (Nov. 20, 2012).

[29] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping,* 77 FR 48,208 (Aug. 13, 2012).

[30] The determination of whether a particular instrument is a swap or otherwise falls within the definition of the term commodity interest can involve a complex analysis and reference to voluminous authorities (the SEC and CFTC joint definitions release runs to some 160 pages in the Federal Register). A full discussion of instruments included or excluded from the term "commodity interest" is outside the scope of this Outline.

3. Timing of the Test

Each trading test is applied at the time of any commodity interest transaction. This requires ongoing monitoring of compliance with the tests, the frequency of which will vary depending on how close to the limits the RIC's commodity interest trading activities have come or are likely to come. If the test is exceeded because of market movement, the exclusion is not terminated, but no further commodity interest transactions are permitted as long as the threshold is exceeded.[31]

4. Bona Fide Hedging

Commodity interest positions used for "bona fide hedging" need not be counted for calculation of either trading test. However this carve-out is narrow. It does not cover derivatives used for risk management, duration management or interest rate hedging, or replication/equalization purposes. Only a transaction that hedges a portfolio position may be excluded as bona fide hedging.[32]

5. Net Notional Value

For the net notional value test, net notional value is calculated (i) for each futures position by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit; (ii) for each option position by multiplying the number of contracts by the size of the contract, adjusted by its delta, in contract units (taking into account any multiplier specified in the contract), by the strike price per unit; (iii) for each retail forex transaction, by calculating the value in U.S. Dollars for such transaction, at the time the transaction was established, excluding for this purpose the value in U.S. Dollars of offsetting long and short transactions, if any; and (iv) for any cleared swap by the value as determined consistent with the terms of part 45 of the CFTC's regulations.

The RIC may net futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and swaps cleared on the same designated clearing organization, where appropriate. Netting is not permitted for uncleared swaps.[33]

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[31] *See* CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions – CPO/CTA: Amendments to Compliance Obligations (Aug. 14, 2012) (the "CFTC August FAQ"), *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/faq_cpocta.pdf.

[32] The definition of "bona fide hedging" for purposes of Rule 4.5 can be found in CFTC Letter 12-19 (October 12, 2012). Rule 4.5, as adopted, incorporated the definition of bona fide hedging as it was set forth at the time in CFTC Rules 1.3(z)(1) and 151.5. These definitions had been adopted (in the case of Rule 151.5) and amended (in the case of Rule 1.3(z)(1)) by the CFTC's rules imposing "position limits" for certain futures and economically equivalent swaps (the "position limit rules"), issued in November 2011. *See Position Limits for Futures and Swaps*, 76 FR 71,626 (Nov. 18, 2011) (establishing position limits); Rule 4.5 Amendment Release at 11,252. However, subsequent to the amendment of Rule 4.5, the position limit rules were vacated by the U.S. Court of Appeals for the District of Columbia Circuit. *See International Swaps & Derivatives Ass'n v. CFTC*, 887 F.Supp.2d 259 (D.D.C. 2012). Vacation of the position limits rules, including among them the definitions of bona fide hedging, left uncertainty as to the status of the definitions of bona fide hedging for purposes of Rule 4.5. On October 12, 2012, the CFTC issued CFTC Letter No. 12-19, which stated that the definition of bona fide hedging would remain as set forth in Rule 151.5 and Rule 1.3(z) prior to those Rules being vacated.

[33] On January 25, 2013, the Managed Funds Association and ICI requested that the CFTC grant relief to permit sponsors of RICs and privately offered investment funds to net certain uncleared swaps held by a fund when applying the net notional test. As of the date of this Outline, this request is still pending.

E. The Marketing Test

1. General Statement of the Test

To satisfy the marketing test under Rule 4.5, the RIC must not be marketed to the public as a commodity pool or otherwise as a vehicle for trading in the commodity futures, commodity options, or swaps markets. This is a facts and circumstances test.

2. The Seven Factors

In the Rule 4.5 Amendment Release, the CFTC stated that the following factors, among others, should be considered and may be indicative of marketing a RIC in a manner inconsistent with this restriction:

(1) name of the RIC;

(2) whether the RIC's primary investment objective is tied to a commodity index;

(3) whether the RIC makes use of a controlled foreign corporation for its derivatives trading;

(4) whether the RIC's marketing materials, including its prospectus or disclosure document, refer to the benefits of the use of derivatives in a portfolio or make comparisons to a derivatives index;

(5) whether, during the course of its normal trading activities, the RIC or the entity acting on its behalf has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives;

(6) whether the futures/options/swaps transactions engaged in by the RIC or on behalf of the RIC will directly or indirectly be its primary source of potential gains and losses; and

(7) whether the RIC is explicitly offering a managed futures strategy.

3. Not All Factors are Equal

The CFTC has indicated that not all of these factors are weighted equally. For example, the "managed futures strategy" factor will be weighted most heavily in determining whether a RIC has been marketed as a vehicle for investing in commodity interests. On the other hand, inclusion of the term "futures" or "derivatives" in the RIC's name is not dispositive, and mere disclosure that the RIC may engage in derivatives trading incidental to its main investment strategy and the risks associated therewith will not violate the marketing restriction.

4. Controlled Foreign Corporations ("CFCs")

The CFTC specifically identified the use of a CFC for trading in commodity interests as a factor to be considered in applying the marketing test. The CFTC stated that use of a CFC alone will not result in failure of the marketing test, although use of such a company to the maximum permitted extent (25 percent of a RIC's portfolio) may indicate trading in excess of the *de minimis* limits.

5. Ongoing Review of the Marketing Test

The marketing test applies on an ongoing basis, and requires review of RIC disclosure documents, including the prospectus, statement of additional information ("SAI"), and annual and semi-annual reports to shareholders, as well as advertising and other promotional materials (including the RIC and adviser websites). For purposes of evaluating the sixth factor (impact of commodity interests on the RIC's performance), management's discussion of fund performance in shareholder reports is likely to be relevant, as are any attribution analyses performed by management. Ongoing review of the marketing test may also involve training sales personnel and arrangements with third party distributors.

F. Application of Rule 4.5 to Funds of Funds

1. Commodity Pool Status of Funds of Funds.

The CFTC takes the position that a fund that invests in a commodity pool, including in other funds, ETFs, or other vehicles that are considered commodity pools (a "fund of funds"), may itself be a commodity pool, even though the top-tier fund owns only securities of the underlying funds. Application of the trading restrictions to funds of funds is a source of considerable uncertainty and very little guidance from the CFTC is available at this time.

2. Impact of "Inadvertent Commodity Pools"

Under the CFTC staff's views, many funds (including RICs) that would not ordinarily be thought of as funds of funds may nonetheless be considered funds of funds for these purposes as a result of the CFTC's expansive view of the definition of the term commodity pool. For example, a RIC's investments in mortgage REITs, certain securitization vehicles, ETFs, and other pooled vehicles that trade in swaps or other commodity interests may trigger fund-of-funds status, and thus require some type of look-through commodity interest trading analysis. [34]

3. Former Appendix A

Prior to the amendment of Rule 4.5, the CFTC had provided some guidance to CPOs of private funds operating as funds of funds that wished to claim an exemption from CPO registration under Rule 4.13(a)(3), in the form of an Appendix to Part 4 of the CFTC's regulations ("Appendix A"). Rule 4.13(a)(3) requires compliance with a *de minimis* trading test (with two alternative calculation methods) similar to the test now required by Rule 4.5. Appendix A enumerated certain specific fact patterns or "situations" under which the top-tier fund could infer compliance with the Rule 4.13(a)(3) trading tests, where the top-tier fund did not have the information necessary to perform the calculations directly.

While Appendix A was withdrawn by the CFTC in connection with the February 2012 amendments, the CFTC staff has stated that funds (including RICs) may continue to rely on Appendix A until further guidance is provided. [35] Appendix A, however, provides only limited guidance

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[34] See discussion of "inadvertent commodity pools" accompanying note 22 above.

[35] *See* CFTC August FAQ, *supra* note 31.

that does not address the range of fact patterns and issues that RICs face or the "inadvertent commodity pool" issue, described above.[36]

4. The Funds-of-Funds No-Action Letter

The CFTC staff has recognized that the top-tier fund often does not know the commodity interest positions of the underlying funds, in particular the holdings of unaffiliated funds, or holdings on a real-time basis. The staff has further recognized that this lack of visibility by the top-tier fund makes it virtually impossible to calculate compliance with the *de minimis* trading test on a direct "look-through" basis, and that the limited situations-based approach of Appendix A does not provide sufficient guidance.

For these reasons, on November 29, 2012, shortly before the December 31, 2012 registration deadline for RIC CPOs, the CFTC staff issued a no-action letter effectively extending the CPO registration deadline for advisers to funds-of-funds where (a) the amount of commodity interest exposure to which the top-tier fund is directly exposed does not exceed the trading limits and (b) the adviser does not know, and cannot reasonably know, that the top-tier fund's indirect exposure to commodity interests derived from investments in underlying funds exceeds the levels specified in Rule 4.5, either calculated directly or through the use of Appendix A.[37] In this letter, the CFTC staff said that enforcement action would not be recommended against the CPO of a fund of funds in that situation for failure to register as such until the later of June 30, 2013 or six months from the date the CFTC issues revised guidance on the application of *de minimis* threshold calculations in the context of Rule 4.5.[38] In order to rely on the no-action relief, the adviser must file a notice claiming the relief with the CFTC.

As of the date of this Outline, the CFTC has not provided fund-of-funds guidance.[39]

G. Filing, Disclosure, Ongoing Compliance

1. Initial Filing

A claim of exclusion from the CPO definition under Rule 4.5 requires a notice of eligibility filing with the NFA through its electronic exemption filing system. Either the RIC, the RIC's

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[36] Appendix A provided guidance in six specific "situations," each of which is composed of a described fact pattern and an "application" that indicates how and whether a fund of funds under the situation's fact pattern could comply with the *de minimis* tests in Rule 4.13(a)(3). For example, under Situation 2, where a top-tier fund invests only in underlying funds, each of which claims the exemption under Rule 4.13(a)(3), Appendix A states that the top-tier fund may also consider itself to be in compliance with the Rule's *de minimis* trading restrictions. Situation 4 permits a fund of funds to invest in underlying funds about which the fund of funds has actual knowledge of the trading limits and commodity interest positions of the underlying funds (affiliated funds), and to aggregate commodity interest positions across underlying funds to determine compliance with Rule 4.13(a)(3), provided the fund of funds does not directly invest in commodity interests.

[37] CFTC Letter No. 12-38 (Nov. 29, 2012).

[38] *Id.* Note that the CFTC staff has indicated that fund-of-fund advisers may both file a claim for the Rule 4.5 exclusion and a claim for the no-action relief, and a number of fund-of-fund advisers have taken this approach.

[39] *See* Compliance with Registration Requirements Under Amended Regulations 4.5 and 4.13(a)(3) by Funds of Funds (Feb. 26, 2013), *available at* http://www.ici.org/pdf/27052.pdf.

adviser, or both may make the filing to claim the exclusion, which must identify the RIC or series (in a multi-series RIC) as the qualifying entity .[40]

The notice of eligibility must include representations that the person claiming the exclusion will:

i. operate the RIC in a manner consistent with the trading and marketing tests;

ii. disclose in writing to each participant, whether existing or prospective, that the RIC is operated by a person who has claimed an exclusion from the definition of the term "commodity pool operator" under the CEA and, therefore, is not subject to registration or regulation as a CPO under the CEA; and

iii. submit to such special calls as the CFTC may make to require the qualifying entity to demonstrate compliance with the provisions of Rule 4.5.

2. Annual Filing

Each person claiming the exclusion under Rule 4.5 must (i) affirm the notice (and the representations) annually, within 60 days of the calendar year end, (ii) withdraw the exemption due to cessation of activities requiring registration or exemption therefrom, or (iii) withdraw the exemption and apply for registration within 60 days of the calendar year end, all through the NFA's electronic exemption filing system.

3. Disclosure

Rule 4.5 requires that any person who has claimed the exclusion from the CPO definition available thereunder must disclose in writing to each participant, whether existing or prospective, that the pool is operated by a person who has claimed an exclusion from the definition of the term "commodity pool operator" under the CEA and, therefore, is not subject to registration or regulation as a pool operator under the CEA.

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[40] *See* ICI Submits Letter to CFTC Requesting Temporary Extension for Registration Applications Filed with NFA; NFA Provides Guidance on Several Issues (email dated Dec. 21, 2012) ("ICI Notice"). The NFA's guidance includes the following:

- If you are filing a 4.5 notice for the first time, you may file in the name of the trust or corporation for a series company. The qualifying entity should always be the series of the trust or corporation and never the corporation or trust itself (unless the corporation or trust has no series). If you file this way, the adviser will need a separate CTA exemption; Rule 4.14(a)(8) may be available, which requires a separate filing by the adviser.

- You can also file a 4.5 notice with the adviser as claimant. If you file this way, you would make a separate filing for each series of a trust or corporation, with each series of the trust or corporation as the qualifying entity. If you file in this way, the adviser may be able to rely on the CTA exemption in Rule 4.6, which does not require a filing.

- If you have 4.5 notices on file, and the adviser will need to register as CPO for a fund that can no longer rely on the rule, you may ask that the notices on file for those funds that can continue to rely on the rule be modified so that they are in the name of the adviser (rather than the fund). This does not have to be done - it is your option. Please note, however, that how a firm files its notice may affect which CTA exemption is available to it. See the discussion in [the bullets above].

The disclosure requirement of Rule 4.5 includes a proviso that the disclosure must be made in accordance with the requirements of any other federal or state regulatory authority to which the "qualifying entity," in this case the RIC, is subject. Under the terms of the Rule, the qualifying entity may make this disclosure by including the information in any document that its other federal or state regulator requires to be furnished routinely to participants, or, if no such document is furnished routinely, the information may be disclosed in any instrument establishing the entity's investment policies and objectives that the other regulator requires to be made available to the entity's participants.

RICs typically provide this disclosure in their prospectus or SAI. If the use of commodity interests is a principal investment strategy for a RIC, it would be appropriate to include this disclosure in the prospectus. While the disclosure requirement has always been a component of Rule 4.5, and was not changed in the amendments, developments in connection with the Rule amendments may require adjustments in the disclosure. For example, disclosure adjustments may be appropriate where the claim for exclusion has been modified to name the adviser rather than the RIC as a claimant (see the discussion of "Who is the Excluded RIC CPO?"). In addition, where a RIC that previously claimed the Rule 4.5 exclusion no longer does so under the amended Rule, and the adviser has registered as CPO with respect to the RIC, the previous Rule 4.5 disclosure will need to be revised accordingly.[41]

4. Authorized Person

All notices must be filed by a representative duly authorized to bind the person claiming the exclusion.

5. Ongoing Compliance with Rule 4.5

In the event any of the information in the representations made in the notice of eligibility for the Rule 4.5 exclusion becomes inaccurate or incomplete, the person claiming the exclusion must amend the notice within 15 days of the occurrence of the event. The exclusion claimed ceases to be effective upon any change that would render (a) the person claiming the exclusion or the qualifying entity for which it is claimed ineligible or (b) either the representations made in the notice claiming the exclusion inaccurate or the continuation of such representations false or misleading. Note that the representations that must be made in the filing include representations that the CPO does and will operate the RIC in compliance with the trading and marketing restrictions.

Because the marketing and trading tests must be met on an ongoing basis, Rule 4.5 RICs and their advisers need an ongoing compliance program. This compliance program should be tailored to the operations of the particular RIC. For example, when the CPO has retained one or more sub-advisers, this should include, as appropriate, representations by sub-advisers as to their compliance with the trading test with respect to the RIC or sleeve managed by the sub-adviser. Where a RIC has more than one sub-adviser, the CPO will need to coordinate the testing at the RIC level.

Additional considerations for ongoing compliance are discussed above, under "Timing of the Trading Test" and "Ongoing Review of the Marketing Test."

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[41] With respect to any disclosure that the adviser is registered as a CPO, note that Section 4o of the CEA provides that "It shall be unlawful for any commodity trading advisor, associated person of a commodity trading advisor, commodity pool operator, or associated person of a commodity pool operator registered under this Act to represent or imply in any manner whatsoever that such person has been sponsored, recommended, or approved, or that such person's abilities or qualifications have in any respect been passed upon, by the United States or any agency or officer thereof. This section shall not be construed to prohibit a statement that a person is registered under this Act as a commodity trading advisor, associated person of a commodity trading advisor, commodity pool operator, or associated person of a commodity pool operator, if such statement is true in fact and if the effect of such registration is not misrepresented."

6. Exclusion Claimed on Fund-by-Fund Basis

An investment adviser may claim the Rule 4.5 exclusion for some but not all of the RICs it advises. A RIC CPO that advises both CPO RICs and Rule 4.5 RICs will not be considered as acting in its registered capacity for Rule 4.5 RICs.[42]

V. CPO Registration

A. Registration as a CPO

An applicant for CPO registration must complete and file Form 7-R with the NFA, through its online registration system. Form 7-R serves as a CPO's application for CFTC registration as well as its application for NFA membership as a CPO. The registration is not effective until it has been approved by the NFA.[43]

B. Principals

An applicant for CPO registration must identify all principals of the CPO and file a Form 8-R for each individual principal. Principals that are natural persons must submit fingerprint cards for a background check.

Rule 3.1(a) defines the term "principal" to include directors, executive officers (the president, chief executive officer, chief operating officer, chief financial officer, chief compliance officer, and any other person in charge of a principal business unit, division or function subject to CFTC regulation), and any person occupying a similar status or performing similar functions having the power, directly or indirectly, to exercise a controlling influence over the CPO's activities subject to CFTC regulation.[44] In addition, "principal" includes: (i) any individual that directly or indirectly owns ten percent or more of the CPO's voting securities or is entitled to receive ten percent or more of the profits, (ii) any entity that directly owns ten percent or more of the CPO's voting securities, and (iii) any person who has contributed ten percent or more of the capital of the CPO.

C. Associated Persons

Section 4k(2) of the CEA makes it unlawful for any person to be an "associated person" of a CPO unless such person is registered with the CFTC. Section 4k(2) and Rule 1.3(a)(3) define an

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[42] *See* Rule 4.5(g) ("The filing of a notice of eligibility or the application of 'non-pool status' under this section will not affect the ability of a person to qualify for an exemption from registration as a commodity pool operator under § 4.13 in connection with the operation of another trading vehicle that is not covered under this § 4.5.").

[43] In December 2012, due to the significant volume of new CPO and CTA registration applications filed with the NFA as a result of the 2012 rule changes, and resource limitations affecting the NFA's ability to process these filings by the December 31, 2012 registration deadline, the CFTC issued no-action relief for CPOs, CTAs, and the principals and associated persons thereof, who were required to register as a result of the amendments to CFTC Rule 4.5 or the rescission of CFTC Rule 4.13(a)(4). *See* CFTC Letter No. 12-68 (Dec. 21, 2012). Under the terms of the no-action relief, the CFTC would not take any enforcement action so long as the aforementioned persons (1) on or before December 31, 2012, completed and filed with the NFA a registration application, including, as appropriate, Forms 7-R and 8-R, as well as any required fingerprint card for each of their principals and associated persons and; (2) subject to the foregoing, on and after January 1, 2013, were subject to, and complied with, the CEA and the CFTC's regulations applicable to their activities as a CPO or CTA, or principal or associated person thereof, as if such persons were in fact registered or approved in such capacity.

[44] For CPOs that are general partnerships or limited liability companies, the general partner and managing member, respectively, would also be considered principals.

"associated person" of a CPO to mean any natural person who is "a partner, officer, employee, consultant, or agent (or any natural person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged." An associated person is thus, in effect, anyone who is a sales person or who supervises sales persons.

With respect to supervisory persons, the CFTC has advised that "all persons, regardless of position title, who supervise associated persons" must register as associated persons.[45] The CFTC has further provided that not only must immediate supervisors register as associated persons, but everyone in the "line of supervisory authority" must do so, no matter how high up in the organization the person with supervisory authority is, or how far down the soliciting persons are on the organization chart.

If a person is required to be registered as an associated person, being listed as a principal of the member firm is not sufficient. The person must also file with the NFA an application for associated person registration. As discussed below, there are exemptions from registration provided under the CFTC rules and CFTC guidance for certain associated persons of a CPO.

1. Requirement of at Least One Principal that is an Associated Person

NFA Bylaw 301(a)(iii) states that "no person, unless eligible for membership in the contract market category, shall be eligible to become or remain a Member unless at least one of its principals is registered as an 'associated person' under the Act and Commission Rules. If any Member fails to have at least one principal that is registered as an 'associated person' NFA shall deem that Member's failure to be a request to withdraw from NFA membership and shall notify that Member accordingly."

2. Requirement that a Branch Office Manager Must be an Associated Person

Each manager of a branch office must register as an associated person (see the discussion below under "Branch Offices").

3. Proficiency Requirements

Associated persons must meet certain proficiency requirements imposed by the NFA. Generally, an associated person of a CPO must have passed the National Commodity Futures Examination (Series 3) within the two years preceding the person's application to become a member of the NFA.[46] Branch office managers must also a Series 30 Branch Office Manager Futures Examination. In general, the Series 3 examination relates to futures, options, and related regulations, while the Series 30 examination focuses on regulatory requirements.

In certain cases, associated persons may satisfy alternative proficiency requirements or seek a waiver of the Series 3 or 30 examinations. NFA Registration Rule 401 exempts associated persons whose activities that are subject to CFTC jurisdiction are limited to swaps. The NFA may waive the examination requirements for certain individuals who are associated with CPOs that are required to register solely because they operate commodity pools principally engaged in securities transactions, who commit only a small percentage of their assets as initial margin deposits and premiums for futures and

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[45] *Interpretative Statement Regarding the Scope of the Term "Supervision" in the Associated Person Registration Requirement,* [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,069 (CFTC, Aug. 14, 1980).

[46] *See* NFA Registration Rule 401.

options on futures, and who use futures transactions and options on futures only for hedging or risk management purposes.[47] The individual or firm requesting the waiver must provide a written description of the facts that qualify the individual for a waiver.

4. FINRA Exemption from Associated Person Registration

CFTC Rule 3.12(h)(1)(ii) provides that a person is not required to register as an associated person in any capacity if that person is "[e]ngaged in the solicitation of funds, securities, or property for a participation in a commodity pool, or the supervision of any person or persons so engaged, pursuant to registration with the [Financial Industry Regulatory Authority ("FINRA")] as a registered representative, registered principal, limited representative or limited principal, and that person does not engage in any other activity subject to regulation by the Commission." Therefore, any associated person of a CPO that is involved solely in the solicitation of investors for investment in funds that the CPO advises, and who is acting pursuant to the person's registration with FINRA as a registered representative, registered principal, limited representative or limited principal, would be exempt from associated person registration with the CFTC or NFA.

5. Swaps Designation

As of January 1, 2013, registered CPOs whose activities include swaps subject to the jurisdiction of the CFTC must be approved as NFA Member swaps designated firms. The associated persons of these Members who are engaging in swaps activity subject to the CFTC's jurisdiction must be approved as swaps associated persons by the NFA. These designations do not involve any major substantive steps.[48] As discussed above, NFA Registration Rule 401 exempts associated persons whose activities that are subject to CFTC jurisdiction are limited to swaps.[49]

D. Branch Offices

Form 7-R requires a registrant CPO to list each of its branch offices and each branch office manager on the form. A branch office of a CPO includes any location, other than the main business address, at which a CPO employs any person engaged in activities requiring registration as an associated person. This is true even if there is only one person at the location. If the firm has one or more branch offices, the NFA's registration records on the firm must include the names of all persons who are branch office managers.[50] A branch office may not itself be a separate corporation or partnership.[51]

CFTC Rule 166.4 requires that a branch office of a CFTC registrant use the name of the firm of which it is a branch for all purposes, and hold itself out to the public under such name. In

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[47] *See* NFA Registration Rule 402.

[48] *See* NFA Notice I-12-24 (Oct. 3, 2012).

[49] *Id.*

[50] Each location must have a branch office manager, and that person's status as a branch office manager should be listed in the Registration Categories section of the person's Form 8-R, even if the person is previously listed as a principal in that section of the Form. Each branch office must have a different manager.

[51] In CFTC Interpretative Letter No. 84-10 (May 29, 1984), it was concluded that a branch office could not maintain a separate identity from the member firm. The requirement that a branch office hold itself out to the public under the name of the member firm is intended to ensure that customers are always aware of the member firm with which they are doing business. It is necessary that any branch office associated person, even one operating out of a residence or an unrelated place of business, make sure that customers understand whom they are doing business with.

interpreting this provision, the CFTC and its staff have consistently taken the position that a registrant may not operate separately incorporated branch offices and that a branch office must use the name of the registrant.[52] Where a registrant's branch office shares the same facilities with other business entities, the CFTC staff stated, "a branch office must be clearly identified as such and must, through all means of communication, hold itself out to the public as a branch office separate and distinct from other business entities that share the same facilities."[53] The CFTC staff stated further that "separate entrances, clear signs and other denotations of the branch office's status as a branch of [the registrant] and indicia of the independent nature of the branch office from the host business are essential to compliance with Rule 166.4."[54]

VI. The Harmonization Exemptions and Accompanying Rule Amendments

A. Overview of the Harmonization Exemption

Registered CPOs typically are subject to extensive regulation with respect to disclosure, shareholder reporting, recordkeeping, and other aspects of their operations under Part 4 of the CFTC's regulations ("Part 4"). The final Harmonization Rules, issued on August 13, 2013, provide exemptions from some of these rules for RIC CPOs and CPO RICs (the "Harmonization Exemptions"). Specifically, the Harmonization Rules adopt a "substituted compliance" approach for disclosure and shareholder reporting. A RIC CPO may claim exemptions from the CFTC's CPO disclosure and shareholder reporting rules based on SEC compliance by the RIC CPO and CPO RIC, subject to additional filing, disclosure and other requirements. The Harmonization Exemptions also include an exemption for RIC CPOs from one aspect of the Part 4 CPO recordkeeping requirements.

This section of the Outline addresses the relief provided by the Harmonization Exemptions and the requirements for claiming and relying on these exemptions. These requirements are discussed more fully in Part VII, in combination with the Post-Harmonization Rules.

B. Basic Elements of the Harmonization Exemptions – Rule 4.12(c)(3)

The cornerstone of the Harmonization Rules is new Rule 4.12(c)(3). Rule 4.12(c)(3) provides that a RIC CPO may claim relief from the following provisions of Part 4 based on the conditions stated in the Rule.

1. Disclosure Document Relief (Rule 4.23(c)(3)(i))

A RIC CPO may claim an exemption from the requirements of Rules 4.21, 4.24, 4.25, and 4.26 (the Part 4 CPO rules relating to content, NFA filing, and delivery to investors of a "Disclosure Document"), provided that:

> **SEC-Compliant Disclosure**. The disclosure provided with respect to the CPO RIC complies with the provisions of the 1940 Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the regulations thereunder, and any guidance issued by the SEC or any division thereof (Rule 4.12(c)(3)(i)(B)); and

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[52] CFTC Interpretative Letter No. 98-22 (Mar. 25, 1998).

[53] *Id.*

[54] *Id.*

Similar Account Performance. The CPO of a CPO RIC with less than a three-year operating history discloses the performance of all accounts and pools that are managed by the CPO and that have investment objectives, policies, and strategies substantially similar to those of the CPO RIC (Rule 4.12(c)(3)(i)(A)).

2. Shareholder Reporting Relief (Rule 4.12(c)(3)(ii))

A RIC CPO may claim an exemption from the monthly account statement distribution requirements of Rule 4.22(a) and (b), provided that:

NAV Availability. The CPO must cause the current net asset value per share of the CPO RIC to be available to participants (Rule 4.12(c)(3)(ii)(A)); and

Disclosure of NAV Availability. The CPO must cause the CPO RIC to clearly disclose:

- that the information will be readily accessible on an Internet Web site maintained by the CPO or its designee or otherwise made available to participants;
- the means through which the information will be made available; and
- the Internet address of such Web site, if applicable (Rule 4.12(c)(3)(ii)(B)(i) and (ii)).[55]

3. Relief from Disclosure of Fund Records to Shareholders (Rule 4.12(c)(3)(iii))

A RIC CPO may claim an exemption from the provisions of Rule 4.23 (the CPO recordkeeping rule) that requires that a CPO's books and records be made available to participants for inspection and/or copying at the request of the participant.

C. Claiming the Harmonization Exemptions – Rule 4.12(d)

In order to claim the relief available under Rule 4.12(c), a RIC CPO (or applicant for registration as a RIC CPO) must file with the NFA a claim of exemption, using the NFA's electronic exemption filing system. The claim must provide the name, main business address and main business telephone number of the CPO claiming the relief and the name of the RIC for which the claim is being made (Rule 4.12(d)(1)(i) and (ii)). The filing must also contain representations that the RIC will be operated as a 1940 Act registered investment company and that the CPO will comply with the requirements of Rule 4.12(c)(3), and must specify the relief sought (Rule 4.12(d)(1)(iii) and (iv)).

The claim of exemption must be filed before the date the RIC CPO commences relying on the exemption and is effective upon filing, provided that the filing is complete (Rule 4.12(d)(2)(i) and (ii)(A)). The filing will cease to be effective upon any change that would render the representations made in the filing inaccurate, or the continuation of the representations false and misleading (Rule 4.12(d)(2)(ii)(A)). The claim is effective only for the RIC for which it has been made, and will not affect the CPO's obligations with respect to any other pool (Rule 4.12(d)(4)).

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[55] The ICI has also requested clarification that Rule 4.12(c)(3)(ii) exempts RIC CPOs from the obligation to prepare the account statements as well as from the obligation to distribute them. Letter from the ICI to the CFTC DSIO, Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators (Aug. 28, 2013) (the "ICI August Letter"), *available at* http://www.ici.org/pdf/27509.pdf.

D. Rule Amendments Accompanying the Harmonization Rules

In connection with adopting the Harmonization Rules, the CFTC also adopted a number of additional rule amendments that are applicable to all registered CPOs. These amendments were designed to reduce or eliminate regulatory requirements in connection with the Part 4 CPO requirements that the CFTC had determined, in the course of considering the Harmonization Rules, were not necessary for CPOs more generally.

1. Limited Recordkeeping Relief for all Registered CPOs

a. The "Main Business Office" Requirement

Historically, Rule 4.23 has required a registered CPO to make and keep books and records specified in the Rule at its "main business office." In connection with the Harmonization Rules, the CFTC amended Rule 4.23 to permit books and records not maintained at the CPO's main business office to be maintained by the pool's administrator, custodian, or distributor, or by a bank or broker-dealer serving a similar function for the pool. A new paragraph (c) of Rule 4.23 requires a CPO that has delegated recordkeeping obligations to one of these entities to make a filing with the NFA, which includes certain representations by both the CPO and the entity keeping the records. This provision is further discussed in Part VII of the Outline.

The CFTC adopted similar amendments to Rule 4.7(b). Rule 4.7(b) provides exemptions from the specific recordkeeping requirements of Rule 4.23 to registered CPOs of private funds that offer and sell their shares only to qualified eligible persons.

b. Transfer Agent Records

The CFTC amended Rule 4.23(a)(4), which requires registered CPOs to keep certain participant transaction related records, to permit these records to be maintained by the pool's transfer agent or through a list of intermediaries. This provision is further discussed in Part VII of the Outline.

2. Disclosure Document Amendments

These changes relate to the Part 4 CPO Disclosure Document requirements. They do not affect RIC CPOs that claim the Harmonization Exemptions, which exempt RIC CPOs from all of the Disclosure Document requirements.

a. Age of Disclosure Document – Extension from Nine to Twelve Months

The CFTC amended Rule 4.26 to permit a CPO to use a Disclosure Document up to twelve months after the date of the Disclosure Document (amended Rule 4.26 (a)(2)). Previously, Rule 4.26 had permitted the use of a Disclosure Document for no more than nine months after its date.[56]

b. Elimination of Disclosure Document Acknowledgement Requirement

[56] The CFTC also made a parallel change to Rule 4.36 relating to the use of Disclosure Documents by commodity trading advisors.

The CFTC rescinded Rule 4.21(b), which previously required CPOs to obtain a signed acknowledgment of receipt of the Disclosure Document delivered in accordance with Rule 4.21(a) before accepting any funds from an investor.

VII. Ongoing Compliance Obligations of RIC CPOs and CPO RICs

This section of the Outline is intended to provide an overview of the ongoing compliance obligations of RIC CPOs and CPO RICs in the post-harmonization era, including (1) the conditions imposed by the Harmonization Exemptions; (2) the Part 4 CPO requirements that have been triggered by adoption of the Harmonization Rules; and (3) responsibilities based on the IM Guidance Update.[57] The discussion is organized by the following subject areas:

- Disclosure;
- Shareholder Reports;
- Financial Statement Filing with the NFA;
- Recordkeeping; and
- Periodic Reporting to Regulators.

The discussion for each subject area includes the relevant compliance dates and identifies the source of each requirement. Note that some of the requirements remain subject to pending requests for clarification or relief.

This discussion assumes that the RIC CPO has claimed all relief available under Rule 4.12(c)(3).

A. Disclosure

RIC CPOs that claim the Harmonization Exemptions need not comply with the content, delivery, and NFA filing, review, and acceptance requirements for Disclosure Documents otherwise required by Rules 4.21, 4.24, 4.25, and 4.26. The following disclosure items are required as conditions of the Harmonization Exemptions or in connection with the Harmonization Rules more generally.

1. SEC Compliance

Requirement. The CPO RIC's disclosure must comply with the provisions of the 1940 Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the regulations promulgated thereunder, *and any guidance issued by the SEC or any division thereof* (emphasis added).

Source. Rule 4.12(c)(3)(i)(B).

Comment. The reference to guidance issued by an SEC division would include, among other SEC guidance, the IM Guidance Update. The IM Guidance Update states, among other things, that prospectus disclosure about a RIC's derivatives activities should be in plain English and should:

- be tailored to the RIC's specific use of derivatives and related risks;

[57] This discussion covers many of the rules in Part 4, but is not a complete catalogue of all Part 4 requirements and does not address other CEA or CFTC rule requirements applicable to RIC CPOs.

- explain the purpose of the RIC's derivatives trading;
- address the degree of exposure (not just the amount invested);
- provide investors with a complete risk profile of the RIC's investments, rather than a list of risks of various derivative strategies; and
- be reviewed on an ongoing basis to assess the completeness and accuracy of derivatives disclosure in light of the RIC's actual use of derivatives.[58]

It remains to be seen to what extent the NFA or CFTC will review a CPO RIC's adherence to these guidelines in connection with the examination of RIC CPOs or other means of reviewing compliance with the Harmonization Rules. However, in the spirit of substituted compliance, it would be expected that the NFA and CFTC will defer to the SEC in interpreting the IM Guidance Update.

Compliance Date. The CPO RIC's initial registration statement or, for an existing RIC, its first post-effective amendment that is an annual update to an effective registration statement, filed on or after November 22, 2013.[59]

2. Similar Account Performance for Recently Launched RICs

Requirement. The CPO of a CPO RIC with less than a three-year operating history (a "new RIC") must disclose the performance of all accounts and pools managed by the CPO that have investment objectives, policies, and strategies substantially similar to those of the new RIC.

Source. Rule 4.12(c)(3)(i)(A).

Comment. Neither the Harmonization Rules nor the release accompanying the adoption of the Harmonization Rules (the "Harmonization Release") provide any specific guidance for preparing and presenting similar account performance for new RICs. For example, the CFTC has not provided guidance as to the following matters:

- format and content of such disclosure;
- how performance should be calculated;
- which accounts should be considered substantially similar;
- placement in the prospectus or SAI (although it is clear that the disclosure should not be in the summary prospectus);
- appropriate disclosure of similar account performance for shorter periods than the history of the new RIC, or where there are no similar accounts; or
- treatment of proprietary accounts.

Instead, the CFTC refers to two SEC staff no-action letters (the "SEC Letters") that permit, but do not require, a RIC to show the performance of funds and accounts that are managed by the same investment adviser as the RIC and that have investment objectives, policies, and strategies

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[58] Note that the IM Guidance Update applies to all RICs that engage in derivatives trading, not only to CPO RICs.

[59] For closed-end RICs, compliance is required in the initial registration statement or when the closed-end RIC is required to update its registration statement, on or after November 22, 2013.

substantially similar to those of the RIC, under certain conditions.[60] Under the SEC Letters, the performance must be shown in a manner that is not misleading and that does not obscure or impede the understanding of information about the RIC that is required to be disclosed under the federal securities laws.

IM Guidance Update. The IM Guidance Update reiterates the staff's position that a RIC may include in its prospectus prior performance of other accounts managed by the RIC's adviser that have investment objectives, policies, and strategies substantially similar to those of the RIC, if the information is not misleading and does not obscure or impede the understanding of required information. The IM Guidance Update does not provide additional guidance on any of the topics set forth above. However, the IM Guidance Update notes "in particular, that a fund should not exclude the performance of any other funds or private accounts that have substantially similar investment objectives, policies and strategies if the exclusion would cause the performance shown to be materially higher or more favorable than would be the case if the funds or accounts were included." The IM Guidance Update does not indicate whether inclusion of similar account performance for the first time will require a Rule 485(a) filing for a post-effective update.

Compliance Date. The CPO RIC's initial registration statement or, for an existing RIC, its first post-effective amendment that is an annual update to an effective registration statement, filed on or after November 22, 2013.[61]

3. NAV Availability

Requirement. The RIC CPO must cause the CPO RIC to clearly disclose:

- that the NAV per share will be readily accessible on an Internet Web site maintained by the CPO or its designee or otherwise made available to participants;
- the means through which the information will be made available; and
- the Internet address of such Web site, if applicable.

Source. Rule 4.12(c)(3)(ii)(B)(i), (ii).

Comment. The Harmonization Rules do not require the NAV availability disclosure to be provided in the CPO RIC's "Disclosure Document" or prospectus.[62] However, the prospectus would be an appropriate means of providing the disclosure.

Note that this disclosure requirement is in connection with the requirement to make the NAV per share available to "participants," which are defined as persons with "any direct financial interest" in a pool. For CPO RICs that are sold only to insurance company separate accounts or funds of funds, the means of disclosure may be tailored accordingly.

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60 Nicholas-Applegate Mutual Funds (Aug. 6, 1996); ITT Hartford Mutual Funds (Feb. 7, 1997).

61 For closed-end CPO RICs, compliance is required in the initial registration statement or when the closed-end RIC is required to update its registration statement, on or after November 22, 2013.

62 Compare, for example, Rule 4.23(c)(1)(D) and Rule 4.12(c)(2)(ii)(B), both of which specify that the required disclosure must be in the pool's Disclosure Document.

Compliance Date. October 21, 2013.

4. Activities of Controlled Foreign Corporations ("CFCs")

Requirement. A CPO RIC that uses a wholly-owned CFC must disclose in its prospectus information about the RIC's investment in the CFC and the principal risks associated with the CFC investment, including those related to swaps and other commodity interests.

Source. Harmonization Release, 78 FR at 52,319.

Comment. As discussed above, CFCs are considered separate commodity pools for which the CPO must comply with applicable CPO Disclosure Document requirements and other CPO regulations. Because CFCs are not RICs, the CPO for the CFC may not rely on the Harmonization Exemptions with respect to the CFC. However, in the Harmonization Release, the CFTC stated that a CFC is not required to prepare a separate Disclosure Document if the CPO RIC prospectus provides the disclosure described above.[63]

Compliance Date. There is no express guidance on the compliance date for this disclosure, and it is likely that most CPO RIC prospectuses will already include it. However, CFC disclosure should be reviewed and conform to this requirement no later than the RIC's initial registration statement or first post-effective amendment that is an annual update filed on or after October 21, 2013.

5. Rule 481 Cautionary Legend Adjustment to Refer to the CFTC

Requirement. The legend required by SEC Rule 481, under the Securities Act of 1933, to be on the outside front cover page of a RIC's prospectus must be revised for a CPO RIC to refer to the CFTC.

Source. Harmonization Release, 78 FR at 52,315.

Comment. The Harmonization Release provides two examples:

- The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or passed upon the adequacy of this prospectus. Any representation to the contrary is a criminal offense.
- The Securities and Exchange Commission and the Commodity Futures Trading Commission have not approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

Compliance Date. The adjusted legend should be used in the CPO RIC's initial registration statement or first post-effective amendment that is an annual update filed on or after October 21, 2013 (or at such earlier time as the CPO RIC revises its prospectus).

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[63] *See* CFTC August FAQ, *supra* note 31.

6. Location of Books and Records

Requirement. Where a RIC CPO relies on Rule 4.23(c) (maintenance of records other than at the CPO's main business office), the CPO RIC must disclose in its "Disclosure Document" the location of CFTC-required books and records.

Source. Rule 4.23(c)(1)(D) (requires a CPO making the filing to agree to disclose in the pool's Disclosure Document the location of CFTC-required books and records).

Comment. The ICI has requested confirmation from the CFTC that this disclosure requirement may be satisfied by disclosing the location of the CPO's books and records as required by Item 33 of Form N-1A or Item 32 of Form N-2. These items, which are in Part C of the RIC's registration statement, require the RIC to disclose "the name and address of each person maintaining physical possession of each account, book, or other document required to be maintained by Section 31(a) [of the 1940 Act] and the rules under that section."[64]

Compliance Date. November 22, 2013.

7. Disclosure of Board Oversight of Derivatives

Requirement. RICs should review their SAI disclosure of Board oversight of risk management as it relates to the RIC's derivatives trading.

Source. IM Guidance Update and Form N-1A Item 17(b).

Comment. Item 17(b)(1) of Form N-1A requires RICs to "disclose the extent of the board's role in the risk oversight of the Fund, such as how the board administers its oversight function and the effect that this has on the board's leadership structure."

The IM Guidance Update reminds RICs and their Boards as follows:

> "In adopting this requirement, the SEC noted that funds face a number of risks, including investment risk. The SEC also stated its belief that the required disclosures would improve investor understanding of the role of the board in the fund's risk management practices and should provide important information to investors about how a fund perceives the role of its board and the relationship between the board and the fund's adviser in managing material risks facing the fund (footnotes omitted)."

Compliance Date. Any necessary adjustment should be made no later than the CPO RIC's next post-effective amendment that is an annual update.

8. Post-Harmonization CPO Disclosure

Following the amendments to Rule 4.5, CPO RIC registration statements typically included disclosure to the effect that the adviser had registered as a CPO, but that the CFTC had not adopted rules determining what the impact on the CPO or RIC would be. This disclosure should be adjusted as appropriate now that the Harmonization Rules have been adopted.

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[64] *See* ICI August Letter, *supra* note 55.

B. Shareholder Reports

1. Periodic Account Statements

CFTC Rules 4.22(a) and (b) require CPOs to provide periodic "Account Statements" to pool participants (monthly for pools with more than $500,000 in assets and quarterly for smaller pools).

RIC CPOs claiming the Harmonization Exemptions are not required to provide these periodic statements to shareholders as long as the CPO:

- makes NAV per share available to shareholders; and
- causes the CPO RIC to disclose the information about NAV availability and how shareholders may obtain the NAV (as described above in Part VII(A)(3)).

Compliance Date. October 21, 2013.

2. Annual Reports

Rule 4.22(c) requires registered CPOs to provide pool participants with an Annual Report that includes pool financial statements meeting certain specific content requirements. The Harmonization Rules do not provide an express exemption from this requirement.

However, the Harmonization Release indicates that RIC CPOs are not required to provide Annual Reports to CPO RIC shareholders under Rule 4.22(c), as long as they provide shareholders with SEC-compliant annual and semi-annual reports and file a Form N-CSR for the RIC with the SEC (as required by SEC rules), and file the RIC's audited annual financial statements with the NFA within ninety days after the RIC's fiscal year end. The ICI has requested confirmation of this guidance.[65]

Compliance Date. The CPO RIC's SEC-compliant financial statements must be filed with the NFA ninety days after the CPO RIC's first fiscal year ending after October 21, 2013.

3. Treatment of CFCs

For purposes of the periodic account statement requirements of Rule 4.22(b) and (c), CFCs are treated as master funds in a master feeder structure, and are not required to provide these statements to shareholders of the CPO RIC.[66]

C. Financial Statement Filing with the NFA

Rule 4.22(c) requires registered CPOs to file the Annual Report delivered to participants (described above) with the NFA within ninety days of the end of the pool's fiscal year. The CPO must also file with the NFA certain "key financial balances" from the Annual Report.

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[65] *See* ICI August Letter, *supra* note 55.

[66] *See* CFTC August FAQ, *supra* note 31; Rule 4.22(c)(8).

The Harmonization Rules do not provide an express exemption from the Rule 4.22(c) NFA filing requirement, either for the CPO RIC or the CFC. However, the Harmonization Release states that "[t]he CPO of a RIC will be required to file the financial statements with the [NFA] that it prepares pursuant to its obligations with respect to the SEC."[67]

1. RIC Financial Statements

The ICI has requested confirmation of discussions with the CFTC staff to the effect that these requirements are met if the RIC CPO files the CPO RIC's SEC-compliant annual financial statements (filed with the SEC as part of Form N-CSR) with the NFA within ninety days after the CPO RIC's fiscal year end.[68]

Compliance Date. Ninety days after the RIC's first fiscal year ending after October 21, 2013.

2. CFC Financial Statements

Pursuant to a CFTC staff No-Action Letter, the CPO to a CFC that is wholly owned by a CPO RIC may claim relief from any obligation under Rule 4.22(c) to file with the NFA a separate Annual Report for the CFC where:

- the CFC CPO is also the CPO for the parent RIC;
- the CPO RIC's Annual Report contains consolidated financial statements for the RIC that include the holdings, gains and losses, and other financial statement amounts attributable to the CFC;
- the CPO RIC's financial statements in the Annual Report "separately indicate[ ] the holdings, gains and losses, and other financial statement amounts attributable to the CFC";[69] and
- the CPO submits the CPO RIC's Annual Report to the NFA, in lieu of a separate Annual Report of the CFC, for all applicable fiscal years.

The no-action relief is not self-executing. The CPO must email a notice of claim to dsionoaction@cftc.gov with the subject line "CFC Letter 13-51" that provides: (i) the CPO's contact information; (ii) the capacity (i.e., CPO) and the name of the CFC(s) for which the claim is being filed and the name of the parent RIC matched with each CFC; and (iii) the CPO's signature (*e.g.*, by attaching a PDF with the CPO's signature).[70] The claim is effective on filing, provided that the claim is materially complete and filed in a timely manner.

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67 Harmonization Release, 78 FR at 52,320.

68 *See* ICI August Letter *supra* note 55.

69 The requirement that CFC information be separately identified in the CPO RIC's consolidated financial statements is subject to a pending request for relief. *See* ICI Memorandum No. 27548, CFTC Staff Issues No-Action Relief to CPOs of the Wholly-Owned Subsidiaries of Registered Investment Companies no. 6 (Sept. 6, 2013), *available at* http://www.ici.org/my_ici/memorandum/memo27548.

70 CFTC No-Action Letter No. 13-51 (Sept. 5, 2013).

Additionally, a CPO that has filed a notice of claim under CFTC No-Action Letter 13-51 must notify the NFA of the notice filing on or before December 31, 2013.[71]

Compliance Date. The CPO must file the claim for relief on or before the end of the CPO RIC's first fiscal year ending after October 21, 2013.

3. Fiscal Year End Changes

Rule 4.22(g) requires a registered CPO that elects a fiscal year end other than the calendar year to give written notice of the election to all pool participants and to file the notice with the NFA within ninety calendar days after the pool's formation. If the CPO changes the pool's fiscal year end, the CPO must notify all pool participants and file the notice with the NFA at least ninety days before the change. Under the terms of the Rule, the CPO must continue to use the elected fiscal year for the pool unless it provides the 90 day notice to the NFA and the NFA does not disapprove the change within 30 days after the filing of the notice.

The Harmonization Rules do not provide an exemption from the Rule 4.22(g) notice and NFA filing requirements.

D. Recordkeeping

1. No General Harmonization Relief – Three Specific Changes

Despite requests from the ICI and other members of the fund industry during the comment process on the Harmonization Proposal, the CFTC did not adopt a substituted compliance approach for RIC CPO recordkeeping requirements. These requirements are set forth in Rule 4.23 (records required for CPOs and pools) and Rule 1.31 (keeping, inspection, time periods, and electronic storage requirements for all CFTC-required records). Instead, the CFTC left the basic recordkeeping requirements in place and provided relief for three specific items:

a. Exemption for RIC CPOs from Participant Access Provisions

A RIC CPO claiming the Harmonization Exemptions need not make the CPO RIC's records available to shareholders for inspection and/or copying at the request of the shareholder, as otherwise required by Rule 4.23.[72] Besides filing the claim for the Harmonization Exemptions, this exemption does not require further action by the RIC CPO.

b. Transfer Agent Records and Lists of Intermediaries

Rule 4.23(a)(4) requires the CPO to maintain for each pool "a subsidiary ledger or other equivalent record for each participant in the pool showing the participant's name and address and all funds, securities and other property that the pool received from or distributed to the participant." In response to industry concerns about the feasibility of this requirement for fund shares held through intermediaries in omnibus accounts, the CFTC amended paragraph (a)(4) of Rule 4.23 by adding a statement that this requirement may be satisfied through a transfer agent's maintenance of

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[71] *See* NFA Notice to Members I-13-36 (Nov. 18, 2013), *available at* http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4340.

[72] Rule 4.12(c)(3)(iii).

records or through a list of relevant intermediaries where shares are held in an omnibus account or through intermediaries.[73]

c. Maintenance of Records Other than at the CPO's Main Business Office

Rule 4.23 previously required registered CPOs to maintain all required records at their "main business office." As amended, Rule 4.23 permits records that are not maintained at the CPO's main business office to be maintained by certain specified entities, subject to the requirement that the CPO must make a filing with the NFA that includes representations by both the CPO and the entity maintaining the records.[74] This provision is discussed more fully below in Part 6 of this section.

2. CFTC Recordkeeping Requirements for RIC CPOs

Because the Harmonization Rules do not provide general recordkeeping relief, RIC CPOs (like all other registered CPOs) must keep the books and records required by Rule 4.23 in the manner required by Rule 1.31, subject to the limited exception for records that are maintained by a specified entity, rather than at the CPO's main business office.

Compliance Date. November 22, 2013.

3. Rule 4.23 - General Requirements

Rule 4.23 requires a registered CPO to keep the records specified in the Rule in an accurate, current and orderly manner, in accordance with Rule 1.31 (Rule 1.31 is described below in Part 5). If the required records are maintained at the main business office of the CPO that is outside the U.S., then upon the request of a CFTC representative, the CPO must provide the requested books and records at the place in the U.S. designated by the representative within 72 hours after the CPO receives the request.

4. Rule 4.23 - Record Content Requirements

Rule 4.23 requires registered CPOs to keep specified books and records relating to the pool and records relating to the CPO.

a. Pool Records – Rule 4.23(a)

Rule 4.23(a) identifies twelve categories of records that the CPO must keep for each pool:

(a)(1) Itemized daily records of the pool's commodity interest transactions:

- transaction date;
- quantity;
- commodity interest;
- price or premium;

[73] Rule 4.23(a)(4) (as amended).

[74] Rule 4.23(c).

- delivery month or expiration date;
- whether a put or call;
- strike price;
- underlying contract for future delivery or underlying commodity;
- swap type and counterparty;
- futures commission merchant (FCM) and/or retail foreign exchange dealer carrying the account;
- introducing broker (if any);
- whether the commodity interest was purchased, sold, or offset, exercised, expired, or rolled forward; and
- gain or loss realized.

(a)(2) Journal of original entry (or equivalent record) showing receipts and disbursements of money, securities and other property;

(a)(3) The acknowledgement required by Rule 4.21(b) for each pool participant (this item is moot, as Rule 4.21(b) has been rescinded);

(a)(4) Subsidiary ledger of each participant's transactions (participant's name and address; all funds, securities and other property received from or distributed to the participant). This may be satisfied through transfer agent records or through a list of relevant intermediaries where shares are held in an omnibus account or through intermediaries;

(a)(5) Adjusting and other ledger entries;

(a)(6) General accounting ledger (details of all asset, liability, capital, income and expense accounts);

(a)(7) Transaction confirmations, purchase and sale statements, and monthly pool account statements for each commodity interest transaction (from FCMs and/or retail forex dealers and swap dealers);

(a)(8) All other records, data, and memoranda prepared or received in connection with the pool's operation (including cancelled checks, bank statements, journals, ledgers, invoices and computer generated records);

(a)(9) Marketing materials (each report, letter, circular, memorandum, publication, writing, advertisement, or other literature or advice (including text of standardized oral presentations and media or seminar presentations) distributed or caused to be distributed by the CPO to any existing or prospective pool participant or received by the CPO from any commodity trading advisor of the pool, showing the first date of distribution or receipt);.

(a)(10) Statements of financial condition (monthly or quarterly statements of financial condition, depending on the size of the pool, prepared within 30 days after the end of the period);

(a)(11) Income statements (a statement of income (or loss) for the period between the most recent annual statement of financial condition furnished to the CFTC pursuant to Rule 4.22(c) and the statement of financial condition required by paragraph (a)(10), completed within 30 days after the end of the period); and

(a)(12) Signed reports and other financial records (a manually signed copy of each (i) Account Statement and (ii) Annual Report provided to pool participants pursuant to Rule 4.22, Rule 4.7(b) or Rule 4.12(b), and records of key financial balances submitted to the NFA for each pool Annual Report, which records must clearly demonstrate how the key financial balances were compiled from the Annual Report).[75]

b. CPO Records – Rule 4.23(b)

Rule 4.23(b) requires the CPO to keep records relating to the CPO:

(b)(1) An itemized daily record of each commodity interest transaction of the CPO and each of its principals, showing the same detailed items as listed above under (a)(1) for pool records (if the CPO is a counterparty to a swap, the CPO must comply with the swap data recordkeeping and reporting requirements of Part 45 of the CFTC's Rules);

(b)(2) Each confirmation of a commodity interest transaction, each purchase and sale statement and each monthly statement furnished by an FCM or retail forex dealer to (i) the CPO relating to a personal account of the CPO and (ii) each principal relating to a personal account of the principal.[76]

(b)(3) Books and records of all other transactions in all other activities in which the CPO engages (these books and records must include cancelled checks, bank statements, journals, ledgers, invoices, computer generated records and all other records, data and memoranda which have been prepared in the course of engaging in those "other" activities).[77]

5. Rule 1.31

Rule 1.31 prescribes the time and manner for keeping the required records and includes special provisions for keeping records solely by means of electronic storage. Rule 1.31 requires that required records must be made available for inspection at the CPO's main business office within 48

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[75] The ICI has requested the CFTC staff to confirm that the records called for by paragraphs (a)(10) – (12) of Rule 4.23 are not required for RIC CPOs because they relate to compliance obligations from which RIC CPOs are exempt under the Harmonization Rules. *See* ICI August Letter, *supra* note 55.

[76] The ICI has asked the CFTC to confirm that some or all records referred to in paragraph (b)(2) of Rule 4.23 are not required for RIC CPOs: "Registered Fund CPOs are not required to disclose the performance of their own proprietary accounts or of the proprietary accounts of their principals, but Regulation 4.23(b)(2)(i) and (ii) could be read to technically require Registered Fund CPOs to maintain confirmations of commodity interest transactions for their own accounts and for their principals." *See* ICI August Letter, *supra* note 55.

[77] This category of records, which relates to the CPO's other business activities, is broad and open-ended. The CFTC has indicated that the purpose of this requirement is to ensure that the CPO adheres to its responsibilities relating to the pools it operates, and that, accordingly, Rule 4.23(b)(3) records would be examined only when necessary for that purpose. A CPO's records regarding its other business activities under Rule 4.23(b)(3) are:

> "intended to be inspected only where the other required books and records indicate that such additional inspection is necessary. For example, if in inspecting the books and records that a CPO must keep for its pool the Commission finds a deficiency in the assets of the pool, the Commission would then inspect the books and records of the CPO's other activities to determine whether the missing assets were placed into them."

Revisions of Commodity Pool Operator and Commodity Trading Advisor Regulations; Delegation of Authority, 46 FR 26,004 (May 8, 1981).

hours of a request by a representative of the CFTC or U.S. Department of Justice ("DOJ") and within 72 hours of a request by the CFTC or DOJ if the records are maintained outside of the U.S.

a. Format

Required records must kept in original form (for paper) or native file format (for electronic records). Native file format means an electronic file that exists in the format in which it was originally created.

b. Time Periods

Required records must be kept five years from the date thereof, and must be readily accessible during the first two years (swap records must be kept until the termination, maturity, expiration, transfer, assignment, or novation date of the transaction for records of any swap or related cash or forward transaction, and for five years after such date).

c. Production of Records

The CPO must produce required records or copies thereof:

- promptly;
- upon the request of any CFTC representative;
- in a form specified by the CFTC representative; and
- at the CPO's expense.

d. Electronic Storage Requirements

Electronic storage media used to store required records must:

- preserve the native file format of the records;
- preserve records exclusively in non-rewritable, non-erasable format (*e.g.,* "WORM");
- verify automatically the quality and accuracy of the storage media;
- serialize the original units of storage media and create a time-date record for the required retention period; and
- permit immediate downloading of indexes and records.

Persons using electronic storage media must:

- keep only CFTC-required records on the individual medium (disk or sheets of microfiche); and
- develop and maintain an audit system, the results of which are available at all times for immediate examination by representatives of the CFTC and DOJ.

Persons employing an electronic storage system must provide a representation to the CFTC prior to the initial use of the system, made by the person required to maintain

the records, the storage system vendor, or another third party, stating that the selected electronic storage system meets the requirements of Rule 1.31, accompanied by an oath or affirmation.

e. The Technical Consultant Requirement

Any person who uses only electronic storage media for some records must, prior to the media's use, enter into an arrangement with at least one third party technical consultant. The technical consultant must:

- have the technical and financial capability to perform the undertakings required by Rule 1.31;
- have access to and the ability to download information from the electronic storage medium; and
- file with the CFTC an undertaking in a form acceptable to the CFTC, signed by the technical consultant, that the technical consultant will furnish records preserved in electronic storage on behalf of a person required to keep such records promptly to the CFTC or DOJ upon request.

6. The "Main Business Office" Requirement

a. Records Maintained by "Specified Entities"

Rule 4.23 no longer states expressly that the CPO must maintain the required records at its main business office. However, as amended, Rule 4.23 states that records that are not maintained at the pool operator's main business office shall be maintained by one or more of the following "Specified Entities":

- the pool's administrator, distributor or custodian, or
- a bank or registered broker or dealer acting in a similar capacity with respect to the pool.[78]

b. NFA Filing Requirement - Rule 4.23(c)

In connection with amending the "main business office" provisions of Rule 4.23, the CFTC added a filing requirement for CPOs that do not maintain required records at their main business office.[79] If the CPO does not maintain its books and records at its main business office, the CPO must, at the time it registers as a CPO or delegates its recordkeeping obligations, whichever is later, file a statement that:

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[78] The ICI has requested clarification and relief that would permit records to be held by third-party recordkeepers other than the Specified Entities. *See* Letter from the ICI to the CFTC, Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators (Sept. 24, 2013) ("ICI September Letter"), *available at* http://www.ici.org/pdf/27596.pdf. The Harmonization Release indicates that the CFTC recognized that CPO RICs, as well as other CPOs, often maintain records with a broader category of entities. *See* Harmonization Release, 78 FR at 52,320-321.

[79] *Id. See also* National Futures Association, Notice to Members I-13-28, Filing Requirements for Exemptions Notices under CFTC's Recently Adopted Harmonization Rules (Sept. 30, 2013), *available at* http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4309.

- identifies the name, main business address, and main business telephone number of the person(s) who will be keeping required books and records in lieu of the pool operator;
- sets forth the name and telephone number of a contact for each person who will be keeping required books and records in lieu of the pool operator; and
- specifies, by reference to the respective paragraph of this section, the books and records that such person will be keeping.

c. CPO Representations

The NFA filing must contain representations from the CPO that:

- the CPO will promptly amend the statement if the contact information or location of any of required books and records changes, by identifying in such amendment the new location and any other information that has changed;
- the CPO remains responsible for ensuring that all required books and records are kept in accordance with Rule 1.31;
- within 48 hours after a request by a representative of the CFTC, the CPO will obtain the original books and records from the location at which they are maintained, and provide them for inspection at the CPO's main business office; provided, however, that if the original books and records are permitted to be, and are maintained, at a location outside the U.S., its territories or possessions, the CPO will obtain and provide such original books and records for inspection at the CPO's main business office within 72 hours of such a request; and
- the CPO will disclose in the pool's Disclosure Document the location of the required books and records.

d. Statement from the Specified Entity

The CPO must include with the NFA filing a statement from each person who will be keeping required books and records in lieu of the CPO wherein such person:

- acknowledges that the CPO intends that the person keep and maintain required pool books and records;
- agrees to keep and maintain such records required in accordance with Rule 1.31; and
- agrees to keep such required books and records open to inspection by any representative of the CFTC or the DOJ in accordance with Rule 1.31.

Compliance Date. November 22, 2013 (for RIC CPOs).

E. Periodic Reporting to Regulators

1. General Requirements

a. CFTC Form CPO-PQR

CFTC Rule 4.27 requires registered CPOs to file Form CPO-PQR electronically with the NFA, in accordance with a filing schedule that depends on whether the CPO is a Small, Mid-Sized, or Large CPO, as determined by the amount of the CPO's Aggregated Pool Assets under Management on the close of business of any day during the Reporting Period ("AUM").[80]

- Small CPO - less than $150 million in AUM
- Mid-Sized CPO - at least $150 million but less than $1.5 billion in AUM
- Large CPO- $1.5 billion or more in AUM

b. NFA Form PQR

NFA Rule 2-46 requires all NFA Member CPOs to file NFA Form PQR quarterly, regardless of size.

2. No Harmonization Exemption

The CFTC did not propose or adopt a general harmonization exemption for reporting on Form CPO-PQR.

3. Suspension of Filing Obligations Pending Harmonization

Pending the adoption of final Harmonization Rules, the CFTC and NFA had suspended:

- all obligations of CPOs that function as registered CPOs only to RICs ("RIC-only CPOs") to file Form CPO-PQR or NFA Form PQR; and
- the obligation of CPOs to both CPO RICs and other pools to include CPO RICs when determining reporting thresholds or reporting on Form CPO-PQR and NFA Form PQR.

4. Post-Harmonization Compliance

The adoption of the Harmonization Rules has triggered Form CPO-PQR and NFA Form PQR reporting requirements for RIC CPOs:

- RIC-only CPOs must make their first filing for the reporting period ending December 31, 2013; and

[80] Capitalized terms, not otherwise defined, have the same meanings as those used in Form CPO-PQR.

- CPOs to CPO RICs and other pools must include CPO RICs when determining reporting thresholds and must report information about the CPO RICs for the reporting period ending December 31, 2013.

5. Form CPO-PQR and NFA Form PQR

a. Purpose

Form CPO-PQR is a "data collection" form adopted by the CFTC in February 2012 as a supplement to information collected on Form PF (for private/hedge fund advisers). Both Form CPO-PQR and Form PF are "post financial crisis" forms designed to collect information relevant to assessing systemic risk for review by the Financial Stability Oversight Council.

The CFTC requires RIC CPOs to report on Form CPO-PQR because it believes that the information is necessary to analyze the "risk posed by such investment vehicles to derivatives markets and the broader financial system."[81]

b. Schedules A, B, and C

Form CPO-PQR has three Schedules.

Schedule A. Schedule A is designed to collect basic information about the CPO and each of the CPO's Pools, including information about the Pool's service providers.[82] Schedule A also requires CPOs to disclose each Pool's change in assets under management during the Reporting Period, monthly rates of return, and subscriptions and redemptions.

Schedule B. Schedule B asks for more specific information about each Pool operated by Large and Mid-Sized CPOs, including information about the Pool's creditors, counterparties, borrowings and clearing mechanisms. Schedule B also requires Large and Mid-Sized CPOs to provide the Pool's Schedule of Investments.

Schedule C. Part 1 of Schedule C requires Large CPOs to report aggregate information about the Pools operated by the CPO, including a geographical breakdown of the investments held by those Pools and certain portfolio turnover information. Part 2 of Schedule C solicits information about each "Large Pool" operated by the Large CPO, including information regarding the Large Pool's portfolio liquidity, counterparty credit exposure, risk metrics, borrowing, derivative positions, financing liquidity, participants, and duration of fixed income assets. A Large Pool is one that has a net asset value of at least $500 million.

c. Filing Schedule Based on Reporting Threshold (Size)

Small CPOs. Small CPOs must file Schedule A of Form CPO-PQR annually, within 90 days of the calendar year end.

Mid-Sized CPOs. Mid-Sized CPOs must file Schedule A and Schedule B of Form CPO-PQR annually, within 90 days of the calendar year end.

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[81] Rule 4.5 Amendment Release, 77 FR at 11,266.

[82] Form CPO-PQR defines a "Pool" as having the same meaning as "Commodity Pool" as defined in Section 1a(10) of the CEA.

Large CPOs. Large CPOs must file Schedules A, B, and C quarterly, within 60 days of the quarter end.

d. NFA Form PQR

NFA Form PQR consists of Schedule A and an itemized Schedule of Investments. All CPOs are required to file NFA Form PQR quarterly, within 60 days of the quarter end.

Large CPOs will satisfy their NFA filing requirement by their quarterly filing of Schedules A, B, and C of CFTC Form CPO-PQR within 60 days of the quarter end, as required by Rule 4.27. Small and Mid-Sized CPOs will satisfy the December 31 NFA quarterly filing requirement by filing the applicable schedules of CFTC Form CPO-PQR within 90 days of the close of each calendar year.

e. Substituted Compliance (Almost) by Filing Form PF

A CPO that is also registered with the SEC as an investment adviser (a "dual registrant") and that is required to file Form PF pursuant to the Investment Advisers Act of 1940 and SEC rules thereunder (1) must comply with Rule 4.27 by filing Form PF with the SEC with respect to commodity pools that are private funds and (2) may comply with Rule 4.27 by filing Form PF with the SEC with respect to commodity pools that are not private funds, in lieu of filing Form CPO-PQR.

- Large CPO dual registrants may fulfill their obligations to file Schedules B and C of Form CPO-PQR by properly filing Form PF with the SEC.
- Mid-Sized CPO dual registrants may fulfill their obligations to file Schedule B of Form CPO-PQR by properly filing Form PF with the SEC.

Form PF is not a complete substituted compliance option. The filing of Form PF does not relieve CPOs of their obligation to file Schedule A of Form CPO-PQR or of their obligation to file NFA Form PQR.

f. Pool Assets Under Management

The CFTC staff and the NFA have provided guidance that AUM to be counted and reported for Form CPO-PQR (including for the purpose of determining reporting thresholds) are solely AUM of Pools for which a CPO must act and operate in its capacity as a registered CPO. AUM does not include assets of non-pools or of exempt or excluded pools (pools for which the operator is either excluded from the definition of CPO or exempt from CPO registration).

g. Determination of Reporting Thresholds - Aggregation

For purposes of determining whether a CPO is Small, Mid-Sized or Large, the CPO must aggregate the assets of all Parallel Pool Structures, Parallel Managed Accounts and Master-Feeder Arrangements.[83]

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[83] *See* Instruction 3 of Form CPO-PQR. Instruction 3 to Form CPO-PQR also states that for purposes of determining whether a CPO meets the reporting thresholds for Schedules B and/or C of Form CPO-PQR, the CPO must treat any Pool or Parallel Managed Account operated by any of its Affiliated Entities as though it was operated by the CPO. However, instructions on

- **Parallel Managed Account.** Any managed account or other pool of assets that the CPO operates and that pursues substantially the same investment objective and strategy and invests side by side in substantially the same assets as the identified Pool.
- **Parallel Pool Structure.** Any structure in which one or more Pools pursues substantially the same investment objective and strategy and invests side by side in substantially the same assets as another Pool.
- **Master-Feeder Arrangement.** An arrangement in which one or more funds (Feeder Funds) invest all or substantially all of their assets in a single fund (Master Fund). A fund would also be a Feeder Fund investing in a Master Fund if it issued multiple classes or series of shares or interests and each class (or series) invests substantially all of its assets in shares (or interests in) a single underlying Master Fund.

h. Industry FAQ

On June 7, 2013, the ICI and the Investment Advisers Association submitted a request for answers to frequently asked questions ("FAQ") to the staffs of the CFTC and NFA regarding Form CPO-PQR and NFA Form PQR.[84] The FAQ was developed based on insight from industry participants about issues that arose when preparing and filing the Forms and included over 45 questions about both forms.

The CFTC staff has not yet responded to the FAQ and has indicated that it will not provide guidance until "all filers have had adequate time to review and comment on any programmatic or other issues that may arise as a result of these forms."[85]

i. Documenting Assumptions

The CFTC staff has stated that, with respect to filing Form CPO-PQR, prior to the issuance of any guidance, filers are entitled to make reasonable assumptions consistent with a good faith effort in executing their compliance obligations.[86]

- Only Schedules B and C provide space for a CPO to document such assumptions.

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the NFA filing system indicate that aggregation of Pools or Parallel Managed Accounts operated by affiliates is required only if the CPO chooses to file on behalf of the affiliate. This instruction, which is in the form of a "help box" on the NFA's EasyFile system that appears in connection with the field that determines reporting threshold (line 0155), states: "To determine this amount, the CPO must aggregate all Parallel Pool Structures, Parallel Managed Accounts and Master Feeder Arrangements. If you are filing on behalf on any affiliates, you must also treat any Pool or Parallel Managed Account operated by those Affiliated Entities as though it was operated by the CPO. Do not include pools that are exempt under CFTC Reg. 4.5 and 4.13. Please note that for 12/31 filings, the answer here will determine whether or not this filing is due in 60 days or 90 days."

[84] *See* CFTC August FAQ, *supra* note 31.

[85] *See* CFTC August FAQ, *supra* note 31.

[86] Questions for CFTC Staff regarding CFTC Form CPO-PQR and Form CTA-PR and for NFA Staff regarding NFA Form PQR and NFA Form PR (June 7, 2013), *available at* http://www.ici.org/pdf/27286.pdf.

- For assumptions used in Schedule A, it is advisable to create an internal document that explains the assumptions and documents any discussions with NFA or CFTC staff.

j. Rule 4.27 Relief for CFCs

Pursuant to a no-action letter granted by the CFTC staff, the CPO to a CFC that is wholly owned by a CPO RIC may claim relief from any obligation under Rule 4.27 to provide a separate report with respect to such CFC to the NFA where:

- the CFC CPO is also the CPO for the parent RIC;
- the CPO provides a consolidated report for the RIC that includes the data for its CFCs to the NFA pursuant to Rule 4.27(c) for the next applicable Reporting Period following the compliance date;
- the CPO either: currently consolidates the RIC's wholly-owned CFC's financial statements with those of the parent RIC's financial statements for financial reporting purposes; or is in the process of converting from separate financial reporting to consolidated financial reporting for the RIC and CFCs it operates; provided that: (1) such CPO operates at least one RIC that currently consolidates its CFC for financial reporting purposes; and (2) such CPO's other RICs consolidate their CFCs for financial reporting purposes for the next applicable Reporting Period following the compliance date; and
- for all subsequent Reporting Periods after the compliance date, the CPO files a consolidated report consistent with the relief provided in the letter or makes a separate filing on behalf of the CFC pursuant to Regulation 4.27(c).

The no-action relief is not self-executing. The CPO must email a notice of claim to dsionoaction@cftc.gov with a subject line "CFC Letter 13-51" that provides: (i) the CPO's contact information; (ii) the capacity (*i.e.*, CPO) and the name of the CFC(s) for which the claim is being filed and the name of the parent RIC matched with each CFC; and (iii) the CPO's signature (*e.g.*, by attaching a PDF with CPO's signature).[87]

Additionally, a CPO that has filed a notice of claim under CFTC No-Action Letter 13-51 must notify the NFA of the notice filing on or before December 31, 2013.[88]

Compliance Date. The claim for relief must be filed on or before December 31, 2013.

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[87] *See* CFTC No-Action Letter No. 13-51 (Sept. 5, 2013).

[88] *See* NFA Notice to Members I-13-36 (Nov. 18, 2013), *available at* http://www.nfa.futures.org/news/newsNotice.asp?ArticleID=4340.

VIII. NFA Requirements for All CPOs

A. General Function of the NFA

The NFA is the independent, self-regulatory organization for the U.S. derivatives industry, including on-exchange traded futures, retail forex transactions, and swaps. NFA membership is mandatory for all registered CPOs, as well as other regulated participants in the commodity interest markets.

The CFTC has authorized the NFA to perform a number of key functions that involve direct interaction with CPOs and their associated persons, as well as other CFTC registrants. For example, the NFA handles the registration process for CPOs and their associated persons, conducts reviews of CPO Disclosure Documents, and conducts examinations of registered CPOs and other Members.

The NFA has also adopted rules applicable to its Members that govern many of the same areas addressed by Part 4 of the CFTC's regulations (such as disclosure, shareholder reporting, recordkeeping, and reports to the NFA), as well as additional conduct and operations-related matters (such as ethics training, business continuity planning, and supervision of associated persons). NFA rules are subject to CFTC approval, and NFA decisions are subject to CFTC review.

B. Deferral of Harmonization-Related Rules

Following the 2012 amendments to Rule 4.5, RIC CPOs were required to become Members of the NFA in addition to registering as CPOs with the CFTC. Because the CFTC and NFA operational rules imposed similar obligations on CPOs, certain NFA rule requirements that related to subjects that the CFTC was likely to address in its harmonization rulemaking were deferred.

In a letter to the NFA, the ICI confirmed the specific items for which RIC CPO compliance would be deferred, as appropriate, until the compliance date resulting from the CFTC's harmonization rulemaking or the amendment of any NFA rules to conform with final harmonization requirements (the "Compliance Date").[89]

The ICI confirmed in the letter the five NFA rules at issue for CPOs and the reasoning for deferral of the relevant requirements. While the NFA has not expressly addressed this issue subsequent to adoption of the Harmonization Rules, it appears that the requirements of the NFA Compliance Rules described in paragraphs 1-4, below, that were deferred pending the harmonization rulemaking have been addressed by the Harmonization Rules, and that the NFA Rules should not impose any additional requirements on RIC CPOs. The obligation of a RIC CPO Member to file quarterly reports in accordance with Rule 2-46, addressed in paragraph 5, below, has now been triggered, beginning with the quarter ending December 31, 2013.

1. Compliance Rule 2-10

This rule requires that CPOs maintain adequate books and records. Because recordkeeping was a specific topic of the harmonization rulemaking, compliance with SEC regulations for books and records was deemed to constitute compliance with Rule 2-10 until the Compliance Date.

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[89] Letter from the ICI to the NFA, NFA Regulations as Applied to Registered Investment Companies and their Advisers (Dec. 28, 2012), available at http://www.ici.org/pdf/12_ici_nfa_rics_advisers.pdf.

2. Compliance Rule 2-13

. Under this rule, CPOs must disclose certain fees and expenses in their Disclosure Documents. Because the presentation of performance, fees, and expenses was expected to be addressed in the harmonization rulemaking, compliance with these requirements was deferred until the Compliance Date.

3. Compliance Rule 2-29

This rule relates to communications with the public and promotional materials and imposes a number of specific content and procedural requirements on NFA Members. Because the CFTC was expected to cover presentation of performance materials and other issues related to the marketing of CPO RICs in the harmonization rulemaking, compliance with related SEC requirements was deemed to constitute compliance with the specific requirements of Compliance Rule 2-29 until the Compliance Date. Compliance with the more general anti-fraud requirements of Compliance Rule 2-29(a) and (b)(1) and (2), as well as the anti-fraud requirements in CFTC Rule 4.41, were not deferred. Compliance by a CPO RIC's principal underwriter or other broker-dealer responsible for the functions addressed in Compliance Rule 2-29 is discussed below.

4. Compliance Rule 2-35

This rule contains requirements related to the content and the delivery of CPO Disclosure Documents. Because this subject was expected to be addressed by the harmonization rulemaking, compliance with SEC requirements for the content and delivery of these documents was deemed to satisfy Compliance Rule 2-35 until the Compliance Date.

5. Compliance Rule 2-46

As discussed above in Part VII, this rule requires registered CPOs to file quarterly reports with the NFA on NFA Form PQR. Because reporting under the CFTC's Part 4 regulations, including under Rule 4.27, was a principal focus of harmonization, compliance with CPO reporting to the NFA under Compliance Rule 2-46 was deferred until the Compliance Date. Compliance with Rule 2-46 is now required for RIC CPOs, starting with the Form PQR for the quarter ending December 31, 2013.

C. Deferral of Rules Relating to Review, Approval and Supervision of Promotional Materials

RIC promotional material is typically prepared by the RIC's principal underwriter or another broker dealer, and not by the RIC CPO itself. These materials are prepared, reviewed, and approved for use in accordance with procedures established pursuant to the rules of FINRA, the self-regulatory counterpart to the NFA in the securities industry, and consistent with the advertising and communications standards established by the SEC and FINRA.

Pending further NFA review of how the SEC and FINRA rules addressing these topics compare with the NFA rules, compliance by a CPO RIC's principal underwriter (or by another broker-dealer) with FINRA's review, approval, filing, recordkeeping, and supervision requirements for RIC promotional materials will be deemed to satisfy a RIC CPO's obligation to comply with NFA Compliance Rules 2-9, 2-29 and related interpretive notices, as applicable. This deferral applies, without limitation, to radio and television advertisements, emails that are promotional in nature, and websites.

The NFA's review remains ongoing, and thus the substituted compliance approach is still in effect.

D. NFA Bylaw 1101

NFA Bylaw 1101 prohibits an NFA Member from carrying an account, accepting an order or handling a transaction in commodity futures contracts for or on behalf of any non-Member of the NFA that is required to be registered with the CFTC as an FCM, introducing broker, CPO, or CTA. Bylaw 1101 by its terms imposes strict liability on any Member conducting customer business with a non-Member that is required to be registered.

Generally, Bylaw 1101 requires CPO Members to determine, through the conduct of appropriate due diligence, whether any participants in their pools are required to be registered. The NFA has recognized that RIC CPOs may not be able to comply fully with Bylaw 1101 with respect to CPO RICs, because, as a result of the distribution channels used with respect to RICs, the RIC CPO does not currently have access to information relating to the RIC's underlying participants.

Accordingly, the NFA has issued guidance that RIC CPO Members will be considered in compliance with Bylaw 1101 if the RIC CPO ensures that any FCM through which the CPO RIC transacts any commodity interest transactions and any sub-adviser that provides investment management services to the RIC is properly registered in the appropriate capacity and a Member of NFA, or in the case of the sub-adviser, exempt from CTA registration.[90] The RIC CPO Member will not be required to conduct Bylaw 1101 due diligence with respect to the CPO RIC's underlying participants.

In the Notice advising Members of this guidance, the NFA stated that its staff is developing additional guidance for RIC CPOs regarding their due diligence obligations under Bylaw 1101 with respect to a CPO RIC's underlying participants, but that the guidance in the notice would remain in effect until this additional guidance is issued.

E. Current NFA Requirements

There are a number of NFA regulatory requirements that were not deferred, and currently apply to RIC CPOs when they become NFA members. These include:

1. Ethics Training

Ethics training is a supervisory obligation for CPOs under NFA Compliance Rule 2-9. Members of the NFA are required to have written ethics training procedures and to maintain documentation that they have complied with the ethics training requirement. CPOs may determine the frequency, duration, and provider of their ethics training programs. The NFA requires that the procedures address, at a minimum: (1) the topics included in the ethics training program; (2) by whom the training will be provided; (3) the format of the training (*e.g.*, classroom instructions, software, etc.); (4) the frequency with which an NFA member expects its employees to obtain ethics training; and (5) how the CPO will document its compliance of the written procedures.[91] A CPO is advised to choose topics that are relevant and timely to the participants. Topics suggested by the NFA include an explanation of the applicable laws, rules and regulations of self-regulatory organizations, the firm's obligation to observe equitable principles of trade, and avoidance and disclosure of conflicts of interest.

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[90] NFA Notice I-12-34, Guidance on Obligations Under NFA Bylaw 1101 for Commodity Pool Operator Members Advising Pools that are Registered Investment Companies (Dec. 19, 2012).

[91] *See* NFA Interpretive Notice 9051, NFA Compliance Rule 2-9: Ethics Training Requirements (Board of Directors, July 1, 2003).

2. Business Continuity and Disaster Recovery Plan

Compliance Rule 2-38 requires each member to adopt a business continuity and disaster recovery plan reasonably designed to enable it to continue operating, to reestablish operations, or to transfer its business to other members with minimal disruption. The business continuity and disaster recovery plan should cover all essential operations and be tailored to the individual needs of the member. The CPO must make sure its employees are aware of the plan's essential components. At a minimum, the plan must address, as applicable: establishing back-up facilities, systems and personnel in a separate geographic facility or area; copying essential documents and data periodically and storing them offsite; considering and minimizing the impact of business interruptions to third parties; and developing a communication plan to contact essential parties. Each member must update its plan as necessary and periodically assess its effectiveness.[92]

3. Annual Self-Examination.

Compliance Rule 2-9 also requires each member to "diligently supervise its employees and agents in the conduct of their commodity futures activities for or on behalf of the Member." In order to satisfy this requirement, CPOs must review their operations on an annual basis using the NFA's self-examination questionnaire.[93] The self-examination questionnaire focuses on a CPO's regulatory responsibilities and requires members to review the adequacy of their internal procedures. Review of the questionnaires should aid NFA members in recognizing potential problem areas and alert them to procedures that need to be revised or strengthened. The self-examination questionnaire must be reviewed by the appropriate supervisory personnel in a CPO's home or branch office, if applicable. While the self-examination questionnaire is not required to be submitted to the NFA, a CPO must retain an attestation of the questionnaire, signed by an appropriate supervising person, for a period of five years from the date of review, with the questionnaire being readily accessible during the first two years.

4. Annual Questionnaire.

A CPO must submit a completed questionnaire to the NFA each year. The annual questionnaire contains information about the firm and allows the NFA to better understand the composition of its membership as a whole. This allows the NFA to tailor its regulatory programs to its members. Accurate completion of the questionnaire also helps to ensure that the NFA's electronic forms, which in many instances "self populate" with information in the NFA's system, reflect the correct information and thus can facilitate the process of filing the forms.

IX. Outstanding Issues

While the substituted compliance approach reflected in the Harmonization Rules was a welcome improvement from the specter of more full-fledged dual regulation of RIC CPOs, both by the CFTC and NFA under the CEA and the SEC under the federal securities laws, there are remaining concerns and unresolved issues.

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[92] The SEC, CFTC and FINRA have released a joint review of their regulated firms' business continuity plans, presenting certain best practices for the firms to consider and implement as appropriate. *See* Business Continuity and Disaster Recovery Planning Advisory (Aug. 16, 2013), *available at* http://www.sec.gov/about/offices/ocie/jointobservations-bcps08072013.pdf.

[93] NFA Interpretive Notice 9020, NFA Compliance Rule 2-9, 2-36 and 2-39: Self-Audit Questionnaire (Board of Directors, Oct. 6, 1992; revised July 24, 2000 and Apr. 8, 2011).

A. Commodity Trading Advisors ("CTAs") to RICs

The Harmonization Rules do not provide relief for registered CTAs to RICs. Accordingly, advisers to RICs that are registered CTAs and that do not also serve as the RIC's CPO (*i.e.* a sub-adviser to the RIC) will have to identify another exemption from the CFTC's requirements for registered CTAs in order to eliminate or reduce these obligations under Part 4 of the CFTC's regulations.[94]

B. Incomplete Recordkeeping Relief

The Harmonization Rules do not harmonize CFTC and SEC recordkeeping requirements for RIC CPOs. As described above, the CFTC rules, by their terms, limit third-party record keepers to the entities specified in the rule (fund administrators, custodians, distributors, banks, and broker-dealers), require certain records that registered investment companies and their advisers do not currently keep (and that appear inconsistent with exemptions provided by the Harmonization Rules) and impose special provisions on electronic record storage. The CFTC staff has been asked to provide relief expanding the categories of permissible third-party record keepers and to address and resolve these discrepancies.[95]

C. Affiliate Transactions

CFTC Regulation 4.20(c) prohibits a CPO from commingling pool property with the property of any other person. NFA Compliance Rule 2-45 prohibits a member CPO from making loans of pool assets (direct or indirect) to the CPO or its principals. Concerns have been raised that these rules could be inconsistent with SEC relief granted under the affiliate transaction provisions of the 1940 Act that permit registered investment companies and their affiliates to engage in inter-fund lending and other transactions that could be viewed as "commingling" pool property.

The NFA recently adopted amendments to Compliance Rule 2-45 and issued a related interpretive notice that resolve this issue under the NFA Rule. The amendments and notice clarify that transactions by a RIC that are permitted pursuant to the 1940 Act, exemptive rules promulgated under the 1940 Act, exemptive orders issued by the SEC, or no-action letters issued by SEC staff pursuant to Section 17 of the 1940 Act do not violate Rule 2-45. The ICI has requested relief from the CFTC under Rule 4.20(c) that would confirm that transactions and arrangements permitted by exemptive orders and no-action letters issued by the SEC or its staff under Section 17 of the 1940 Act will be deemed not to implicate CFTC Rule 4.20(c), but, to date, the CFTC has not provided a formal response.[96]

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[94] In August of 2012, the CFTC staff stated that the sub-adviser of a RIC whose CPO could no longer rely on Rule 4.5 following the 2012 amendments would not be required to comply with the CFTC's recordkeeping, reporting, and disclosure requirements applicable to registered CTAs until 60 days following the effective date of the final harmonization rules. *See* CFTC August FAQ, *supra* note 31. The ICI has submitted a request to the CFTC staff to confirm that registered CTAs acting in that capacity as sub-advisers to RICs before November 22, 2013, will not be required to comply with the CFTC's CTA disclosure document requirements with respect to those RICs, whether or not another exemption from such requirements is available. *See* ICI September Letter, *supra* note 78.

[95] *See* ICI August Letter, *supra* note 55; ICI September Letter, *supra* note 78.

[96] *See* Letter from the ICI to the CFTC, Follow-up Letter on CFTC Regulation 4.20(c) (Sept. 16, 2013), *available at* http://www.ici.org/pdf/27569.pdf (requesting confirmation that transactions and arrangements permitted by exemptive orders and no-action letters issued by the SEC or its staff under Section 17 of the 1940 Act will be deemed not to implicate CFTC Rule 4.20(c) and providing follow up information); *See also* Letter from the ICI to the CFTC, CFTC Regulation 4.20(c) (Dec. 21, 2012), *available at* http://www.ici.org/pdf/12_ici_cftc_joint_transactions.pdf.

D. Continuing CFTC Jurisdiction

Substituted compliance does not eliminate the CFTC's assertion of jurisdiction over CPO RIC registration statements or other aspects of its CPO regulations with respect to RIC CPOs. In the Harmonization Release, the CFTC made it clear that it retains jurisdiction over RIC CPO disclosure and shareholder reporting, including the ability to enforce a RIC CPO's noncompliance, in the CFTC's view, with the federal securities laws: "[I]n the event that a CPO of a RIC fails to comply with the SEC administered regime, the CPO will be in violation of its obligations under part 4 of the Commission's regulations and thus subject to enforcement action by the Commission." Moreover, the CFTC has indicated that it does not necessarily view the substituted compliance approach as a permanent solution. Rather, the CFTC has stated that the substituted compliance framework is the prudent approach "at this time," while the CFTC "continues to expand its knowledge of RICs and their use of commodity interests" and its understanding of RICs and their use of commodity interests "continues to evolve."

2013 Securities Law Developments Conference

Trends in Fee Litigation:

Section 36(b) and ERISA

December 11, 2013

Panelists

Julia S. Ulstrup, Moderator
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Applicable Laws

- Employee Retirement Income Security Act of 1974 (ERISA)
- Investment Company Act of 1940 (40 Act) – Section 36(b)

Questions for Discussion

- Who sues whom?
- For what are defendants sued?
- What issues are commonly contested?
- What are the key stages in the litigation (i.e., critical turning points)?
- How is the litigation ultimately resolved?

Looking Ahead

- The Future of ERISA and Section 36(b) Litigation
- Impacts (Direct and Indirect) on the Fund Industry
- Cases to Watch

DEVELOPMENTS IN LITIGATION UNDER SECTION 36(b) OF THE 1940 ACT

NOVEMBER 2013

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TABLE OF CONTENTS

Page

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I. INTRODUCTION

Courts have issued more decisions concerning the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq. (the "Act") in the last several years than in the previous two decades. These decisions have focused on the nature and scope of claims under Sections 36(b) of the Act and the factors courts must consider when evaluating claims for excessive fees under Section 36(b).[1]

Investment advisers have been largely successful in defending many of the recent civil lawsuits. The issue of whether there are implied rights of action under various sections of the Act has been decided resoundingly in the negative. As such, essentially the only avenue for private plaintiffs to sue under the Act has been Section 36(b), which provides an express private right of action. Courts have been reluctant to expand that section to allow challenges based on anything other than pure excessive fees, and plaintiffs bringing an excessive fee claim are required to meet a very high standard of proof to recover under the statute.

On March 30, 2010, the Supreme Court of the United States decided Jones v. Harris Associates L.P., 130 S. Ct. 1418 (2010), and expressly adopted the standard established by the United States Court of Appeals for the Second Circuit more than 25 years ago in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982). Under Jones, "to face liability under § 36(b), an investment adviser must charge 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." Jones, 130 S. Ct. at 1426. The decision affirms a standard that makes it difficult to prove a violation of Section 36(b), and potentially closes the door on further attempts by plaintiffs to expand Section 36(b) beyond a narrow type of wrong (i.e., excessive fees).

More recently, plaintiffs have filed actions challenging the fees for funds that rely on sub-advisers for the provision of investment advisory services, a practice that is particularly prevalent in the insurance industry. These so-called "manager of managers" cases assert that the sub-advisers are performing, with minor exceptions, all of the investment management services but only receive a "fraction" of the fee paid to the manager. These cases are the new frontier of Section 36(b) litigation, and generally require the investment manager to demonstrate the services provided by the manager versus the sub-advisers, as well as to explain why sub-advisers are willing to provide day-to-day advisory services for a fraction of the total management fee.

This Outline discusses recent developments and decisions involving these and other topics.

II. SECTION 36(b)—THE EXPRESS RIGHT OF ACTION FOR BREACH OF FIDUCIARY DUTY WITH RESPECT TO RECEIPT OF COMPENSATION

A. Background of Section 36(b)

Congress passed the Act as a comprehensive federal regulatory scheme to protect investment company shareholders from self-dealing and other abuses that were perceived

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[1] See James N. Benedict et al., "The Aftermath of the Mutual Fund Crisis," 38 Rev. of Sec. & Commodities Reg. 261 (Dec. 7, 2005).

to be rampant throughout the mutual fund industry. 15 U.S.C. § 80a-1 (1997) (Findings and Declarations of Policy). Unlike the Securities Act of 1933 and the Securities Exchange Act of 1934, which emphasize disclosure, the Act is more regulatory and remedial in nature. The Act contains various prohibitions and requires the board of directors of an investment company to include "disinterested" persons. 15 U.S.C. § 80a-10(a). The Supreme Court has instructed that these persons serve as "independent watchdogs" who supply "an independent check upon the management." Burks v. Lasker, 441 U.S. 471, 484 (1979).

1. Legislative History

a. As originally enacted, the Act did not effectively monitor fee structures "negotiated" between funds and their investment advisers. Investment Company Amendments Act of 1969, S. Rep. No. 91-184 (1969), reprinted in 1970 U.S.C.C.A.N. 4897, 4901. Instead, the original Section 36 authorized the Securities and Exchange Commission (the "Commission") to bring an action against certain persons affiliated with investment companies for gross misconduct or gross abuse of trust within five years prior to when suit is filed. Pub. L. No. 768, ch. 686 § 36, 76th Cong., 3d Sess. (Aug. 22, 1940), 54 Stat. 841 (emphasis added).

b. As mutual funds experienced rapid growth in the 1950s and 1960s, investment advisers earned fees which did not necessarily reflect perceived economies of scale realized in managing larger funds. Securities & Exchange Commission, Public Policy Implications of Investment Company Growth, reprinted in H.R. Rep. No. 2237, 89th Cong., 2d Sess., 10-12 (1966). Congress determined that the unique structure of the mutual fund industry resulted in closer relationships between mutual funds and their investment advisers than those usually existing between other buyers and sellers of investment advisory services. Because of this closeness, "the forces of arm's-length bargaining [did] not work in the same manner in the mutual fund industry as they [did] in other sectors of the American economy." S. Rep. No. 91-184, at 5, reprinted in 1970 U.S.C.C.A.N. 4897, 4901.

c. In 1970, Congress sought to address the problem by adding Section 36(b) to the Act, 15 U.S.C. § 80a-35(b), thereby imposing a fiduciary duty upon investment advisers in connection with their receipt of compensation.

- Section 36(b) is the only provision under the entire Act which expressly provides private citizens with a right of action. By responding to a specific problem in the mutual fund industry, Congress expressly sought to provide private citizens a right of action to remedy violations in limited circumstances. This is unlike any other provision of the Act.

- By its terms, Section 36(b) is limited to breaches of fiduciary duty involving an investment adviser's receipt of compensation. 15 U.S.C. § 80a-35(b). This provision does not on its face give plaintiffs the right to sue for alleged breaches of general fiduciary duties (compare with Section 36(a), discussed infra Section IV.B).

- Section 36(b) gives private litigants a short, one-year limitations period in which to bring suit. 15 U.S.C. § 80a-35(b). This is in direct contrast with the longer, five-year limitations period given the SEC for enforcement proceedings. E.g., Liaros v. Vaillant, No. 93 Civ. 2170, 1996 WL 88559, at *14 (S.D.N.Y. Mar. 1, 1996); In re ML-Lee Acquisition Fund II, L.P. & ML-Lee Acquisition Fund (Retirement Accounts) II, L.P. Sec. Litig., 848 F. Supp. 527, 542 (D. Del. 1994).

- Damages under Section 36(b) are limited to fees received by investment advisers within the prior year. 15 U.S.C. § 80a-35(b)(3). Only recipients of advisory compensation or other payments shall be liable for damages under Section 36(b). Id.

- Because Section 36(b) is "equitable" in nature, plaintiffs are not entitled to a jury trial. See Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 487 F. Supp. 999, 1001 (S.D.N.Y.), aff'd sub nom. In re Gartenberg, 636 F.2d 16 (2d Cir. 1980), cert. denied sub nom. Gartenberg v. Pollack, 451 U.S. 910 (1981); Kalish v. Franklin Advisers, Inc., 928 F.2d 590, 591 (2d Cir.), cert. denied, 502 U.S. 818 (1991); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), aff'd, 835 F.2d 45, 46 (2d Cir. 1987), cert. denied, 485 U.S. 1034 (1988); Sivolella v. AXA Equitable Funds Mgmt. LLC, Nos. 11-4194, 13-312, 2013 WL 4096239 (D.N.J. July 3, 2013), adopted by, 2013 WL 4402331 (D.N.J. Aug. 15, 2013).

- For a comprehensive analysis of the legislative history and development of Section 36(b), see generally William P. Rogers & James N. Benedict, "Money Market Management Fees: How Much Is Too Much?," 57 N.Y.U. L. REV. 1059 (1982).

2. Initial Litigation—The Excessive Fee Cases

In connection with the increased popularity of money market funds in the 1980s, plaintiffs brought numerous claims under Section 36(b) alleging that investment advisers were charging these funds excessive management fees.[2]

a. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923 (2d Cir. 1982), cert. denied sub nom. Andre v. Merrill Lynch Ready

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[2] Early cases under § 36(b) concerning advisory fees turned on whether plaintiffs, as shareholders in the funds, were required to make a demand on the fund directors before bringing suit. For years, courts uniformly held that such a demand was required under the traditional standards for derivative lawsuits under Rule 23.1. Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928 (3d Cir. 1982), vacated, 465 U.S. 1001, on remand, 730 F.2d 939 (3d Cir. 1984); Grossman v. Johnson, 674 F.2d 115 (1st Cir.), cert. denied sub nom. Grossman v. Fidelity Mun. Bond Fund, Inc., 459 U.S. 838 (1982).

In Fox v. Reich & Tang, Inc., 692 F.2d 250, 252 (2d Cir. 1982), aff'd sub nom. Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984), the Court held that the demand requirement governing derivative actions brought by shareholders of a corporation does not apply to an action brought by an investment company shareholder under § 36(b) of the Act.

Assets Trust, 461 U.S. 906 (1983), was the first case to undertake a comprehensive analysis of the standards courts should apply when evaluating "excessive fee" claims under Section 36(b). In Gartenberg, two shareholders of the Merrill Lynch Ready Assets Trust money market fund brought a derivative action attacking the size of fees paid to the adviser as excessive, in breach of the adviser's fiduciary duty under Section 36(b). Plaintiffs did not claim that individual investors were not getting their money's worth, but rather, that the adviser, due to the size of the fund, was making too much money.

The District Court concluded that Congress was imprecise in delineating the fiduciary duty imposed by Section 36(b), but maintained that the standard is one of fairness. The court dismissed the complaint after applying a three-prong test that examined:

(1) whether the fee was in the range prevailing in the marketplace;

(2) whether the fee was sufficiently disclosed and the services satisfactorily performed; and

(3) whether the scope of the enterprise was adequately disclosed to directors and investors.

Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 528 F. Supp. 1038 (S.D.N.Y. 1981), aff'd, 694 F.2d 923 (2d Cir. 1982), cert. denied sub nom. Andre v. Merrill Lynch Ready Assets Trust, 461 U.S. 906 (1983).

The Second Circuit affirmed, holding that plaintiffs had failed to meet their burden of proving that the fees charged by the adviser were so excessive or unfair so as to amount to a breach of fiduciary duty within the meaning of Section 36(b). Gartenberg, 694 F.2d at 932. The court reviewed the "tortuous" legislative history of Section 36(b) and concluded that, to be guilty of a violation, the fee must be "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." Id. at 928.

The court identified six factors to be considered in determining whether fees charged by the investment adviser were disproportionate to the services rendered: (1) the nature and quality of the services provided to fund shareholders; (2) the profitability of the fund to the adviser-manager; (3) economies of scale of operating the fund as it grows larger; (4) comparative fee structures; (5) fallout benefits—i.e., indirect profits to the adviser

attributable in some way to the existence of the fund; and (6) the independence and conscientiousness of the directors. Id.

b. Subsequent to Gartenberg, plaintiffs in the 1980s were generally unsuccessful in pursuing "excessive fee" claims under Section 36(b). See, e.g., Krinsk v. Fund Asset Mgmt., Inc., 875 F.2d 404, 409 (2d Cir.), cert. denied, 493 U.S. 919 (1989); Schuyt v. Rowe Price Prime Reserve Fund, Inc., 663 F. Supp. 962 (S.D.N.Y.), aff'd, 835 F.2d 45 (2d Cir. 1987), cert. denied, 485 U.S. 1034 (1988). See generally James N. Benedict, Mark Holland & Barry W. Rashkover, "Developments in Management Fee Litigation," Rev. of Sec. & Commodities Reg., Vol. 22, No. 15 (Sept. 13, 1989).

B. More Recent Litigation Involving Section 36(b)

Courts have issued numerous decisions involving Section 36(b) since the mutual fund industry scandal broke in 2003. These cases fall into roughly three categories: (1) "pure" excessive management fee actions under Section 36(b); (2) "manager of managers" actions where plaintiffs attack the fee structure of mutual funds that utilize sub-advisers; and (3) former revenue sharing cases repleaded as pure excessive management fee cases.

1. "Pure" Excessive Management Fee Cases

There are several of the so-called "pure" excessive management fee cases currently pending in United States District Courts throughout the nation. Most of these actions were brought by the same plaintiffs' counsel and contained, at the outset, nearly identical allegations. There have been numerous recent decisions in this category of cases, most notably the Supreme Court's landmark decision in Jones, et al. v. Harris Associates, L.P.

a. Summary Judgment

(4) Following extensive fact and expert discovery, the parties in Jones v. Harris Assoc. L.P., No. 04 C 8305, 2007 WL 627640 (N.D. Ill. Feb. 27, 2007) cross-moved for summary judgment. Plaintiffs' argument in support of their motion focused "on conduct of parties other than Harris or actions of Harris other than receipt of compensation." Instead, plaintiffs claimed that the management agreements were invalid, rendering the associated fees charged thereunder "excessive." According to plaintiffs, the management agreements were invalid because: (1) one trustee "received deferred compensation from Harris, rendering him an interested party in Harris and making him ineligible to vote on approval of any fee agreements"; (2) the trustees' social and professional relationships with fund management precluded them from exercising "independent judgment in

assessing the fees"; and (3) Harris failed to disclose one trustee's compensation and his relationships with other members of the board in relevant public filings. Id. at *5. The court disagreed. In rejecting plaintiffs' arguments, the count held that even if one of the purportedly "independent" trustees was deemed to be, in fact, "affiliated" with the adviser, the overwhelming majority of the remaining members of the Board that approved the subject fees were "independent." Second, the court found that plaintiffs' argument relating to the trustees' business and social relationships with fund management were insufficient to render them "affiliated" with the defendant, holding that plaintiffs failed to demonstrate requisite control of the trustees and a corresponding effect on shareholder interests. Finally, the court held that defendant's purported failure to disclose deferred compensation allegedly remitted to one of the funds' trustee was outside the scope of Section 36(b), finding that "[t]o sweep this conduct into the ambit of § 36(b) would directly contradict the universal view that the fiduciary duty it sets out is both narrow and limited." Id. at *6. Accordingly, the court denied plaintiffs' motion for summary judgment.

The court then turned to defendant's motion for summary judgment. Defendant argued that summary judgment was warranted because: (1) the fees at issue were in line with those charged to substantially similar funds in other fund complexes; (2) the trustees were provided with information relating to each of the subject funds and the trustees approved the fee schedules; (3) the fee schedules included breakpoints that resulted, at least in part, through negotiation efforts by the trustees; and (4) the funds at issue performed relatively well during the relevant time period. See Jones, 2007 WL 627640, at *8. The court began its analysis by discussing the appropriate standard by which claims brought pursuant to Section 36(b) should be viewed. After briefly reviewing the Seventh Circuit's discussion of the issue in Green v. Nuveen Advisory Corp., 295 F.3d 738 (7th Cir. 2002), the court adopted the applicable framework set forth in Gartenberg. Turning its attention to defendant's first argument, the court noted that any comparison of fees required that it consider not only those fees charged to other funds within other complexes, but also those fees charged to defendant's institutional clients. The court nevertheless concluded that an examination of the fees charged to other mutual funds and institutional clients

evidenced that the fees at issue fell within this range, "thus preventing a conclusion that the amount of fees indicates that self-dealing was afoot." Jones, 2007 WL 627640, at *8. Citing its previous discussion rejecting plaintiffs' motion for summary judgment, the court agreed with the defendant's second argument in support of summary judgment, concluding that "[t]he evidence the parties have provided indicate that the board as a whole was operating without any conflict that would prevent it from engaging in arm's-length negotiations with [the defendant]." Id. With respect to defendant's third point, the court found that, although breakpoints could have been set at a lower level, they nevertheless were comparable to the fee structures adopted by other mutual funds, providing a reasonable inference that such breakpoints were the result of arm's-length negotiations. Finally, the court noted that the funds performed well during the relevant time period, rejecting plaintiffs' request that it consider performance outside of the one year look-back period. As a result, the court concluded that summary judgment in favor of the defendant was warranted, holding that "[w]hat matters is whether there is a fundamental disconnect between what the Funds paid and what the services were worth; on this score Plaintiffs have not set forth an issue of fact that, if resolved in their favor, could lead to a finding that [Defendant] had breached its § 36(b) duty." Id. at * 9.

Plaintiffs appealed the district court's decision granting summary judgment to the Seventh Circuit, which affirmed. See Jones v. Harris Assoc. L.P., 527 F.3d 627 (7th Cir. 2008). In doing so, the Seventh Circuit rejected the notion that Section 36(b) empowers courts to engage in price setting and, in affirming summary judgment, relied heavily on the effect of competition in the mutual fund industry and the ability of investors to "vote with their feet." In the court's view, Section 36(b)'s fiduciary duty requires full disclosure and honesty in the fee-negotiation process, but the level of fees is to be established by competitive forces in the market. In so holding, the court explicitly rejected the Second Circuit's approach to the issue, as set forth in Gartenberg. Instead, the court noted, in pertinent part:

> "[J]ust as plaintiffs are skeptical of Gartenberg because it relies too heavily on markets, we are skeptical about Gartenberg because it relies too little on markets . . . . Having had another chance to study this question, we now disapprove of the

> Gartenberg approach. A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth."

Id. at 632. The court also rejected plaintiffs' arguments based on comparisons to fees for institutional products, holding that such comparisons are invalid in light of differences in the management and servicing of those products. Specifically, the court found that:

> "Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions. This complicates an adviser's task. Joint costs likewise make it hard to draw inferences from fee levels. Some tasks in research, valuation, and portfolio design will have benefits for several clients. In competition those joint costs are apportioned among paying customers according to their elasticity of demand, not according to any rule of equal treatment."

Id. at 634-35. Accordingly, the Seventh Circuit affirmed dismissal of plaintiffs' complaint.

Following the Seventh Circuit's affirmance, plaintiffs moved for rehearing en banc. Although the court summarily rejected plaintiffs' motion, a group of five judges filed a dissenting opinion that argued that competition cannot be counted on to solve the problem of excessive mutual fund fees and suggested that fees for institutional products may be a valid benchmark. See Jones v. Harris Assocs. L.P., 537 F.3d 728, 730 (7th Cir. 2008). Specifically, the dissenters cited favorably to a study published by a professor at Northwestern University, which stated that an increasing amount of cronyism between agents in the mutual fund industry lead to increased fees that were borne by shareholders. See id. at 730-31 (citing Camelia M. Kuhnen, "Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry"

(Mar. 1, 2007), available at http:// ssrn. com/ abstract= 849705).

Additionally, the dissenters questioned the panel's reasoning in dismissing comparisons between the fees Harris Associates charged to its retail mutual funds and those charged to its institutional clients. The dissenters found that "[t]he panel opinion throws out some suggestions on why this difference may be justified, but the suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis." Jones, 537 F.3d at 731. Instead, the dissenters cited favorably to a study by economists John Freeman and Stewart Brown, who found that:

> "[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm's-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm."

Id. at 731-32 (citing John P. Freeman & Stewart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," 26 J. Corp. L. 609, 634 (2001)).

The dissenters also expressed dissatisfaction with the panel's formulation of the standard of liability for 36(b) actions; i.e., that the fees must be "so unusual that a court will infer that deceit must have occurred." Id. at 732 (citing Jones, 527 F.3d at 632). In particular, the dissenters found that the "so unusual" standard wrongly emphasized comparing the adviser's fees to those charged by other mutual fund advisers; but that the "governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor." Id.

Arguably, the dissenters' main contention with the panel's opinion may have been more procedural than substantive. The dissenters admitted that "[t]he outcome of this case may be correct", however, they took issue with the panel's

failure to circulate its opinion to the full court prior to its publication, as is the practice with decisions that create circuit splits. Id. The dissenters found that "the creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis warrant our hearing the case en banc." Id. at 732-33.

Seizing upon the language of the five dissenting judges, counsel for the plaintiffs subsequently petitioned the Supreme Court for review of the case. On March 9, 2009, the Supreme Court granted plaintiffs' petition for certiorari. See Jones v. Harris Assoc. L.P., 129 S. Ct. 1579 (2009). On March 30, 2010, in a landmark decision, the Court reversed the Seventh Circuit's decision and, in doing so, unanimously determined that the Second Circuit's decision in Gartenberg appropriately harmonized both the plain language of the statute and Congressional intent, and represented the appropriate standard under Section 36(b). See Jones v. Harris Assocs. L.P., 130 S. Ct. 1418 (2010).

Justice Samuel Alito, writing for a unanimous Court, began the decision by reviewing the historical underpinnings of the statute and its corresponding amendments, noting that Section 36(b) was born out of "problems relating to the independence of investment company boards and the compensation received by investment advisers." See id. at 1422 (internal citations omitted). According to the Court, the "fiduciary duty" standard contained in Section 36(b) represented a "delicate compromise" between protecting shareholder interest and eschewing any formal rate-making authority to be vested with the SEC. See id. at 1423.

The Court then addressed its attention to the meaning of Section 36(b)'s use of the term "fiduciary duty," noting first that in the intervening years since Congress passed the statute, both the judiciary and the SEC repeatedly and consistently have interpreted that language in a manner substantially similar to that adopted by the Second Circuit in Gartenberg. The Court relied on its decision in Pepper v. Litton, 308 U.S. 295 (1939), an "analogous" bankruptcy case wherein the Court looked to trust law, to inform Section 36(b)'s "fiduciary duty" phraseology. In Pepper, the Court found that:

> [t]he essence of the test is whether or not under all the circumstances the transaction carries the

> earmarks of an arm's length bargain. If it does not, equity will set it aside.

See Jones, 130 S. Ct. at 1427 (quoting Pepper, 308 U.S. at 306-07).

According to the Court in Jones, "this formulation expresses the meaning of the phrase 'fiduciary duty' in [Section] 36(b)," and the Gartenberg approach as set forth by the Second Circuit "fully incorporates this understanding of the fiduciary duty set out in Pepper and reflects [Section] 36(b)(1)'s imposition of the burden on the plaintiff." Id. Moreover, the formulation under Gartenberg correctly insists that "all relevant circumstances be taken into account" and properly "uses the range of fees that might result from arm's-length bargaining as the benchmark for reviewing challenged fees." Id.

The Court also noted that the approach set forth in Gartenberg properly reflects Section 36(b)'s place in the overall statutory scheme of the Act, particularly in connection with "its relationship to the other protections that the Act affords investors." Id. According to the Court, scrutiny of investment adviser compensation by both a fully informed and independent board and shareholder suits constitute separate and mutually reinforcing mechanisms for controlling adviser conflicts of interests. See id. at 1427-28. With respect to the independent fund directors, the Act instructs that a measure of deference to a board's judgment may be appropriate in some instances, but that the measure of deference is dependent on the particular circumstances of the case. See id. at 1428. According to the Court, Gartenberg "heeds these precepts." Id.

Although both of the parties in the case endorsed the basic Gartenberg approach, the Court found several fundamental and material disagreements that warranted further discussion. The first of these disagreements centered on whether (and when) a comparison of the fees charged to an adviser's institutional clients is appropriate when assessing the fees charged to retail mutual funds. Finding that the Act requires consideration of all "relevant factors," the Court refused to embrace a bright-line rule and instead instructed courts to "give such comparisons the weight that they merit in light of the similarities and differences between the services that the clients in question require" and cautioned courts to "be wary of inapt comparisons."

Id. In doing so, the Court specifically dismissed concerns that such comparisons would "doom any fund to trial," noting that "plaintiffs bear the burden in showing that fees are beyond the range of arm's-length bargaining," and "[o]nly where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm's-length range will trial be appropriate." Id. at 1429 n.8. In addition, the Court cautioned courts from relying too heavily on comparisons with fees charged to mutual funds by other fund advisers, as such comparisons may not necessarily be appropriate given that other fund adviser fees may themselves suffer from a lack of arm's-length negotiation. See Jones, 130 S. Ct. at 1429.

Finally, the Court found that Section 36(b) requires a court's evaluation of an investment adviser's fiduciary duty to take into account "both procedure and substance." See id. (internal citations omitted). The Court noted that "[w]here a board's process for negotiating and reviewing investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process." Id. (citations omitted). As a result, "if the disinterested directors considered the *relevant factors*, their decision to approve a particular fee agreement is entitled to considerable weight, even if a court might weigh the factors differently." Id. (emphasis added).[3] The Court noted that instances may arise when a board's process was somehow deficient or when the adviser withholds important information. In such circumstances, a reviewing court "must take a more rigorous look at the outcome." Id. at 1430. In so holding, the Court cautioned that the fiduciary duty standard under Section 36(b) "does not call for judicial second-guessing of informed board decisions," nor does it suggest that "a court may supplant the judgment of disinterested directors apprised of all of the relevant information, without additional evidence that the fee exceeds the arm's-length range. See id.

As a result, the Court concluded that the Seventh Circuit, by focusing almost exclusively on the element of

[3] In so holding, the Court embraced the applicability of the Gartenberg factors and further solidified the almost 30 years of jurisprudence that has developed since the Second Circuit's decision was first rendered. See Jones, 130 S. Ct. at 1429-30; see also id. at 1425-26 & n.5 (listing relevant Gartenberg factors).

disclosure, erred, and vacated and remanded the decision for further proceedings. See id. at 1430-31.

(5) In Gallus v. Ameriprise Fin., Inc., 497 F. Supp. 2d 974 (D. Minn. 2007), plaintiffs asserted claims under Sections 12(b) and 36(b) of the Act, claiming that the fees charged to several funds within the American Express-branded family of funds were "excessive." At the conclusion of fact discovery, defendants moved for summary judgment, arguing that there was no genuine issue of material fact based on the evidence relating to the Gartenberg factors regarding whether the fees could not have been the product of arm's-length bargaining under Section 36(b). After setting forth the applicable standard set forth in Gartenberg, the court concluded that there are was no genuine issue of material fact regarding whether the fee was 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. See Gallus, 497 F. Supp. 2d at 984.

With respect to the nature and quality of services provided by the adviser to the funds, the court found that plaintiffs failed to establish a link between alleged misconduct that resulted in several regulatory settlements and the value of services paid for by the challenged fees, and that plaintiffs' characterization of the "undisputed performance figures as 'poor'," standing alone, did not create a genuine issue of material fact. Id. at 980. Next, the court analyzed the profitability of the funds to the adviser, and concluded that plaintiffs' mere assertions that the detailed reports provided by the adviser to the funds were improper because of the cost allocation methodology was insufficient to create a genuine issue of material fact. Id. at 980-81. Furthermore, the court found that the board was provided with detailed reports that expressly addressed certain so-called "fall-out" benefits when negotiating the fees with the adviser, and that plaintiffs' assertions that the profitability or cost data with respect to institutional business constituted a fall-out benefit did not create an issue of material fact. Id. at 980. The court also held that the breakpoints in the subject funds' fee schedules, as well as the fee adjustments based on fund performance, served to share the benefit of economies of scale, and rejected plaintiffs' claim that defendants' should have shared more with the funds based merely on expert testimony that failed to identify what amount of cost savings would have been appropriate. Id. at

981-82. The court then analyzed plaintiffs' contention that the fees charged to non-mutual funds was somehow relevant for determining the excessiveness of the fees charged to mutual funds, concluding that such a comparison was expressly rejected by the Second Circuit in Gartenberg. The court further concluded that, even if such a comparison was somehow relevant, the plaintiffs failed to demonstrate how the services provided to the different types of funds were comparable and that, in any event, the Board had, in fact, been provided with such data. See Gallus, 497 F. Supp. 2d at 982-83. Finally, the court found that the plaintiffs had failed to adduce any evidence that the Board members were not independent and qualified; nor did plaintiffs dispute that the Board met regularly, played an active role in the contract negotiation process, and sought the advice and counsel of third-party consultants. Id. at 983. As a result, the court concluded that summary judgment on plaintiffs' Section 36(b) claim was warranted. Id. at 983-84.

Turning to the remaining claim under Section 12(b), the court held that: (1) plaintiffs' assertion that existing shareholders received "absolutely 'no material benefit'" from the distribution fees was "without merit," noting that "approximately 85% of Defendants' 12b-1 distribution fees were paid for services to existing shareholders and not to marketing the Funds to new shareholders"; and (2) that the evidence established that the Board had, in fact, considered the benefits of the services provided pursuant to the distribution fees. The court dismissed plaintiffs' claim brought pursuant to Section 12(b). Id. at 985.

Plaintiffs appealed the district court's decision to the Eighth Circuit. See Gallus v. Ameriprise Fin., Inc., 561 F.3d 816 (8th Cir. 2009). The Eight Circuit began its substantive analysis by, inter alia, detailing the Second Circuit's decision in Gartenberg and comparing it to the Seventh Circuit's decision in Jones. See id. at 822. Rejecting the Seventh Circuit's reasoning in Jones, the Gallus court concluded that Gartenberg "provide[s] a useful framework for resolving claims of excessive fees," but also found that Section 36(b) provides for a basis of liability independent of, and wholly apart from, any excessiveness of the fee. The Eighth Circuit concluded that "[w]e believe that the proper approach to § 36(b) is one that looks to *both* the adviser's conduct during negotiation and the end result" and that "[u]nscrupulous behavior *with respect to either* can

constitute a breach of fiduciary duty." Id. at 823 (emphasis added). Thus, the court noted that an adviser's conduct in connection with the board's review and approval process may serve as a violation of Section 36(b) even though the fee is in line with those charged by comparable funds and "passed muster under the Gartenberg standard." Id.

In addition to this determination that Section 36(b) provides for an "independent" basis of liability, the Eighth Circuit held that the lower court "erred in rejecting a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients." Id. at 823. In so holding, the Eighth Circuit refused to embrace a bright-line rule, but noted that "the argument for comparing mutual fund advisory fees with the fees charged to institutional accounts is particularly strong in this case because the investment advice may have been essentially the same for both accounts." Id. at 824. As a result, the Eighth Circuit determined that a dispute between the experts retained by the parties here about whether the adviser "purposefully omitted, disguised, or obfuscated information that it presented to the Board about the fee discrepancy between different types of clients" raised a question of material fact precluding the grant of summary judgment in favor of defendants. Id.

Counsel for defendants subsequently petitioned the Supreme Court for review of the case. See No. 09-163, Petition for Cert. Filed, 78 USLW 3083 (U.S. Aug. 6, 2009). On April 5, 2010, the Supreme Court granted the defendants' petition, vacated the lower court judgment, and remanded the case for further consideration in light of the Court's decision in Jones v. Harris Associates L.P., 130 S. Ct. 1418 (2010). The Eighth Circuit's decision was very difficult to reconcile with the Supreme Court's holdings in Jones that Section 36(b) is "sharply focused on whether the fees themselves were excessive," and that instances of non-disclosure (i.e., when the adviser withholds important information from the board) go only to the weight given to the board's approval of the fees. Jones, 130 S. Ct. at 1430.

On remand, the district court reinstated its Order granting summary judgment and re-entered judgment in favor of the defendants. See Gallus v. American Exp. Fin. Corp., Civ. No. 04-4498, 2010 WL 5137419, at *1 (D. Minn. Dec. 10, 2010). The court held that "[i]n Jones, the Supreme Court adopted the Gartenberg framework and reasoning that this

Court used in reaching its summary judgment opinion. And, in its order reversing this Court, the Eighth Circuit specifically noted that this Court properly applied the Gartenberg factors." Gallus, 2010 WL 5137419, at *2.

Plaintiffs appealed the district court's decision, but the Eighth Circuit affirmed. See Gallus v. Ameriprise Fin., Inc., 675 F.3d 1173 (8th Cir. 2012). The Eighth Circuit began its analysis by noting that "Jones has altered the way in which we determine whether an adviser has breached its fiduciary duty under § 36(b). In our previous decision, we held that the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result . . . but after Jones, process-based failure alone does not constitute an independent violation of § 36(b). Instead, we have been instructed that § 36(b) is sharply focused on the question of whether the fees themselves were excessive." Id. at 1179 (internal citations omitted).

The Eighth Circuit stated that the "fee-negotiation process remains crucially important, as it allows the court to determine the amount of deference to give the board's decision to approve the fee." Id. The court then noted that the directors received information on the services provided to the funds, the adviser's profit from the funds, and on institutional fees (at the board's request). The Eighth Circuit decreased the amount of deference accorded to the board's judgment, however, because the directors placed too much significance on the fees charged by the funds' competitors, which "like those challenged, may not be the product of negotiations conducted at arm's length." Id. (quoting Jones, 130 S. Ct. at 1429).

The Eighth Circuit then rejected plaintiffs' claims with regard to the fees charged to Ameriprise's institutional clients. Specifically, the Eighth Circuit noted that "[a]lthough the disparity in fees charged to Ameriprise's different clients is likely relevant to whether the fees fall within the arm's length range, the plaintiffs have failed to set forth the additional evidence required to survive summary judgment." Gallus, 675 F.3d at 1180-81 (internal citations omitted).

The Eighth Circuit next considered plaintiffs' argument that the alleged flaws in the fee-negotiation process constituted additional evidence that the fees violated Section 36(b). The Eighth Circuit rejected this argument,

and noted that "[w]e do not read Jones to allow a deficient process to be the additional evidence required to survive summary judgment . . . because the opinion's language again focuses on evidence that the fee is outside the arm's length range." Id. at 1181.

Finally, the Eighth Circuit rejected plaintiffs' contentions that the district court's "rigorous" review was not "rigorous" enough, and that an adviser runs afoul of Rule 12b-1 if it benefits from a Rule 12b-1 fee. Instead, the Eighth Circuit held that an adviser only violates Rule 12b-1 if such a fee is "outside the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." Id. at 1182 (internal citations omitted).

(6) In Bennett v. Fidelity Management & Research Co., C.A. Nos. 04-11651, 04-11756, 2011 WL 98837 (D. Mass. Jan. 10, 2011), the court issued a decision after briefing and hearing on the defendants' motion for summary judgment in which it held that "[a]fter Jones, the ultimate standard of liability under § 36(b) is whether an investment adviser charged a fee that was so disproportionately large that it bore no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." Id. at *1 (citing Jones, 130 S. Ct. at 1426; Gartenberg, 694 F.2d at 928). The court thereafter ordered plaintiffs to submit supplemental briefing identifying "the evidence they rely upon to place in genuine dispute each applicable Gartenberg factor" and "why those disputed factors would, if decided in plaintiffs' favor, be sufficient to persuade a reasonable finder of fact that the challenged fees were so disproportionately large that they bore no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." Bennett, 2010 WL 98837, at *2. Defendants were ordered to explain in response why the plaintiffs are not entitled to prevail. Id. Plaintiffs subsequently stipulated to dismiss this case with prejudice. See Bennett v. Fidelity Mgmt. & Research Co., No. 04-11651, Stipulation of Dismissal (D. Mass. Jan. 27, 2012).

b. Motions To Dismiss

(1) In Sins v. Janus Capital Mgmt., LLC, No. 04-cv-1647, 2006 WL 3746130 (D. Colo. Dec. 15, 2006), plaintiffs, shareholders of funds within the Janus-branded family of

funds, asserted derivative claims under Section 36(b) of the Act and alleged that the defendant breached its fiduciary duties by providing similar services to institutional clients for substantially lower fees and that defendants failed to pass on the benefits of economies of scale. Defendants moved to dismiss, arguing that plaintiffs' allegations were insufficient to state a claim under Section 36(b) because they were based on observations and criticisms of the mutual fund industry generally and conclusory statements purportedly based upon "information and belief, and did not relate to the disproportionality of the fees at issue. See id. at *2.

The court agreed that plaintiffs' generalized allegations, standing alone, were insufficient to state a cause of action under Section 36(b), and noted that it was both "concerned" and "troubled" by plaintiffs' allegations made on purported "information and belief," finding that such allegations were identical to those in other complaints in unrelated cases. Nevertheless, the court found that the complaint contained facts sufficient to state a claim upon which relief may be granted, and denied defendants' motion. After reviewing the Gartenberg factors and noting that the Tenth Circuit has not expressly adopted those factors, the court analyzed several of the Gartenberg factors in turn, and concluded that plaintiffs' allegations were sufficient to withstand dismissal at the initial pleading stage. See Sins, 2006 WL 3746130, at *3-4.

(2) In Hunt v. Invesco Funds Group, Inc., No. H-04-2555, 2006 WL 1581846 (S.D. Tex. June 5, 2006), plaintiffs asserted derivative claims under Section 36(b) of the Act on behalf of eight different mutual funds in the AIM-branded family of funds. Plaintiffs alleged that the benefits resulting from the marked increase in fund assets were improperly retained by defendants, rendering their advisory and distribution fees "excessive" in violation of the fiduciary duties imposed upon them by Section 36(b). Defendants moved to dismiss, arguing: (1) that plaintiffs failed to allege sufficient facts specific to each of the eight funds at issue, as required by Gartenberg; and (2) even if some allegations were sufficiently specific, they were based on factual and other deficiencies.

The court disagreed and sustained plaintiffs' amended complaint, finding that the allegations as pled were "sufficient to allege a disproportionality between the fees

that Defendants charged each of the funds at issue and the services that Defendants provided to the funds." Id. at *2. Analyzing several Gartenberg factors in turn, the court found that the amended complaint sufficiently set forth allegations pertaining to: (1) the amounts and types of fees charged by defendants for each of the eight funds; (2) the nature and quality of services provided to the funds, both in general and specific terms; (3) the existence of scale economies and the failure of defendants to pass on the resulting benefits to fund shareholders; and (4) the independence and conscientiousness of the funds' trustees. Furthermore, the court pointed out that plaintiffs advisory fee comparisons were sufficient to survive a motion to dismiss, noting that the amended complaint included facts comparing the advisory fees for each of the funds at issue with those "fees charged for equivalent advisory services," including institutional pension accounts managed by defendants as well as "average advisory fees charged for [sic] peer mutual funds." Id. at *2-5.

Finally, the court rejected defendants argument that plaintiffs allegations were "based upon demonstrably false and contradictory premises, which cannot sustain plaintiffs' claims," noting that defendants had "failed to demonstrate that the allegations are contradictory or not well-pled" and were sufficient to state a claim under Section 36(b). Id. at *5.

Following the court's decision, plaintiffs' agreed to dismiss their complaint with prejudice and without costs. See Hunt v. Invesco Funds Group, Inc., No. H-04-2555, slip op. (S.D. Tex. Jan. 29, 2007).

(3) In Dumond v. Massachusetts Fin. Servs. Co., No. Civ. A. 04-11458, 2006 WL 149038 (D. Mass. Jan. 19, 2006), plaintiffs, shareholders of funds within the Massachusetts Financial Services (MFS) fund complex, brought suit under Section 36(b) of the Act. Plaintiffs alleged that defendants failed to pass on the benefits of economies of scale, had charged excessive distribution fees, had provided similar services to institutional clients for substantially lower fees, and paid excessive commissions to broker-dealers in exchange for soft dollars.

On motion to dismiss, defendants argued that plaintiffs did not plead factual allegations sufficient to state a claim under Section 36(b). After reviewing the Gartenberg

factors and noting that the First Circuit has not expressly adopted those factors, Judge O'Toole opined that Gartenberg does not establish a heightened pleading standard for Section 36(b) claims and that the plaintiffs' failure to plead facts that specifically address the Gartenberg factors was not in itself a ground for dismissal. The court held that plaintiffs' allegations were factual, not merely conclusory. The court held that although certain cases could be read as requiring a higher level of factual pleading under Section 36(b) (see Krantz v. Prudential Invs. Fund Mgmt., 305 F.3d 140 (3d Cir. 2002), cert. denied, 537 U.S. 1113 (2003); Migdal v. Rowe Price-Fleming Int'l, 248 F.3d 321 (4th Cir. 2001); Yampolsky v. Morgan Stanley Inv. Advisers Inc., No. 03 Civ. 5710, 2004 WL 1065533 (S.D.N.Y. May 12, 2004)), they were not binding precedent in the District of Massachusetts and were inconsistent with the applicable standard under Fed. R. Civ. P. 8. Furthermore, said the court, the instant action presented a different set of alleged deficiencies than those that led the courts to dismissal in the other cases. Dumond, 2006 WL 149038, at *2-3.

Following Judge O'Toole's decision denying defendants' motion to dismiss, defendants filed a motion for a protective order in an effort to secure a decision: (1) declaring that the damages period applicable to a Section 36(b) claim is limited to only the one year period prior to the filing of the complaint; and (2) prohibiting plaintiffs from seeking discovery after the relevant damages period except to the extent that such documents created after the applicable period contain or reflect responsive information relating to the at-issue period. See Dumond v. Massachusetts Fin. Servs. Co., No. Civ. A. 04-11458, 2007 WL 602589, at *1 (D. Mass. Feb. 22, 2007). Plaintiffs opposed defendants' motion, arguing that the period for which damages may be awarded under Section 36(b) begins one year before the filing of the complaint and continues until the complaint is fully adjudicated and that, even if the court were to limit damages to those accruing within the one year period prior to the commencement of the lawsuit, discovery should not necessarily be limited to events occurring within that limited period. See id. at *1. In support of their position, defendants cited numerous cases, including the Supreme Court's decision in Daily Income Fund v. Fox, 464 U.S. 523, 526 n.2 (1984). After briefly addressing each case in turn, the court noted that, with the sole exception of a lone order by a magistrate

judge, "[i]n all of these cases, the courts were considering the effect of § 36(b)(3)'s backward-looking limitation, and not whether that section imposed a forward-looking one." Dumond, 2007 WL 602589, at *4. With respect to Daily Income, the court found that "the Court's brief reference to the damages period was casual dictum, not a controlling holding," and concluded that Section 36(b)(3) permits ongoing damages on a forward-looking basis. Dumond, 2007 WL 602589, at *5. Accordingly, the court denied defendants' motion for a protective order.[4]

(4) In Turner v. Davis Select Advisers LP, No. 08-CV-421, slip op. (D. Ariz. June 1, 2011), plaintiff asserted causes of action under Sections 36(b), 47, and 48(a) of the Act. Plaintiff alleged that the adviser to and distributor of the Davis New York Venture Fund received disproportionately large Rule 12b-1 fees, and the adviser received excessively disproportionate advisory fees, in violation of Section 36(b). Plaintiff also asserted control person liability against the adviser, and contended that the advisory and distribution contracts should be voided under Section 36(b).

After concluding that plaintiff did have standing to assert the claims (slip op. at 6-9); that the amended complaint related back to the date of filing of the original complaint (slip op. at 9-10); and that the damages period under Section 36(b) is not confined solely to the one year period prior to filing of the complaint (slip op. at 11-12), the court performed a Gartenberg factor-by-factor analysis of the complaint. The court concluded that "[w]hile Plaintiff is correct that '[t]he Amended Complaint Sufficiently Articulates the Gartenberg Factors,' Plaintiff's allegations largely consist of general conclusions, not facts, and Plaintiff does not explain how any of the facts alleged show that a particular fee was '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.'" Slip op. at 13 (quoting Gartenberg, 694 F.2d at 928).

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[4] In a virtually identical "pure" excessive case brought against Putnam, also pending before Judge O'Toole, the court denied defendants' motion to stay a second action brought against Putnam and held that Section 36(b)(3)'s one year limitations period does not impose a forward-looking limitation on damages. See Vaughn v. Putnam Inv. Mgmt. LLC, No. 04-10988, 2007 WL 602596, at *5 (D. Mass. Feb. 22, 2007).

Having concluded that plaintiff failed to state a claim under Section 36(b) against either the adviser or the distributor, the court also dismissed the claim for control person liability under Section 48(a). Slip op. at 19. The court also concluded that Plaintiff was not standing in the shoes of the fund and was not a party to the contracts which he sought to void. As such, the court dismissed plaintiff's Section 47(b) claim. Slip op. at 17-19.

(5) In Reso v. Artisan Partners L.P., No. 11-CV-873, 2011 WL 5826034 (E.D. Wis. Nov. 18, 2011), an investor in several funds managed by Artisan brought suit claiming that Artisan's advisory fees violated Section 36(b) of the Act. The court rejected Artisan's motion to dismiss.

The court first considered Artisan's arguments that many of plaintiff's allegations should be disregarded because they were alleged on "information and belief" and because many were copied from complaints filed by plaintiff's lawyers in other lawsuits. The court rejected these arguments noting that the "mere fact that allegations are somewhat generic and have been pled elsewhere does not give the Court sufficient indicia that [plaintiff's] lawyers failed to reasonably inquire into the circumstances in this case." Id. at *4-5.

The court then evaluated plaintiff's claims using the Gartenberg factors as a framework, and noted that "the Court will deny Artisan's motion to dismiss even if [plaintiff] has failed to allege certain of the Gartenberg factors, so long as [plaintiff's] complaint, taken as a whole, alleges facts that demonstrate a plausible claim for relief under Section 36(b)." Id. at *6.

First, the court found that plaintiff satisfied the factor concerning the independence and conscientiousness of the board by alleging that the directors did not receive sufficient information, and that the directors permitted the funds to pay higher fees than Artisan's institutional clients. While the court noted that "[l]ike many of [plaintiff's] allegations, this one slips in by the skin of its teeth, [the allegations] are sufficient to satisfy the Court at this stage of the case." Id. at *6-7.

The court then found that plaintiff satisfied the nature and quality of services factor by alleging that "other than standard investment advising services, Artisan provides

only de minimis services to the funds at issue in this case," and that the funds pay for their own transfer agency, legal and accounting services." Id. at *7. The court also found that despite high Morningstar rankings in other fields, the funds' "F" fee ratings "nonetheless raise an inference that the nature and quality of Artisan's services may be viewed as deficient by outside analysts of mutual funds." Id.

Likewise, the court found that plaintiff satisfied the comparative fees factor by alleging that Artisan charged lower fees and provided higher breakpoints to its institutional clients. Id. at *8-9.

The court found that plaintiff's "strongest" allegations related to the economies of scale factor because plaintiff "sufficiently establish[ed] that Artisan's fee is reduced only slightly over the course of amassing a large amount of assets, but that Artisan does not suffer significant additional expenditures over the course of that expansion. Therefore, the Court finds that Artisan is not appropriately passing on those economies of scale to the mutual funds." Id. at *9.

Finally, the court found that plaintiff satisfied the profitability factor by alleging facts "sufficient to show that Artisan reaps too great a benefit from the funds in this case." Id.

Defendants subsequently filed a motion for summary judgment, but the case settled shortly thereafter. See Reso v. Artisan Partners L.P., No. 11-CV-873, Order (E.D. Wis. Aug. 23, 2012).

(6) In Laborers' Local 265 Pension Fund v. iShares Trust, No. 3:13-cv-00046, 2013 WL 4604183 (M.D. Tenn. Aug. 28, 2013), plaintiffs, investors in certain iShares exchange traded funds, filed a derivative action on behalf of the funds, asserting claims under Sections 36(a), 36(b) and 47(b) of the Act and seeking the return of allegedly "excessive" fees, contractual rescission and injunctive relief. Plaintiffs asserted the claims against the funds as nominal defendants, as well as BlackRock Fund Advisors ("BFA"), BlackRock Institutional Trust Company, N.A. ("BTC") and individual directors of the funds. BFA acted as investment adviser to the funds, while BTC was hired by BFA to act as securities lending agent to the funds. Plaintiffs sought to recover revenue derived from BTC's lending of the funds' securities, alleging that the 35 percent

fee-split of this revenue, approved by the funds' directors, was excessive. Id. at *1-2.

Plaintiffs also alleged that an additional 5 percent of securities lending revenue was paid to BlackRock affiliates as administrative fees, resulting in a "40/60 division of revenue between the BlackRock affiliates and the iShares funds" that was likewise excessive, when compared to fees paid by "peer mutual funds, and, in particular, compared to funds which employ unaffiliated lending agents." Id. at *2.

In dismissing plaintiffs' Section 36(b) claim, the court relied primarily on an SEC Exemption Order issued pursuant to Sections 6(c) and 17(b) of the Act, which applied to the securities lending agreement at issue. The court explained that because Section 36(b)(4) of the Act provides that Section 36(b) is inapplicable to payments or compensation made in connection with orders under Section 17 of the Act, plaintiffs' Section 36(b) claim must be dismissed. Id. at *3, *5-6.

The court also dismissed plaintiffs' claims under Sections 36(a) and 47(b), finding that plaintiffs failed to overcome the presumption that no private right of action exists under those sections of the Act. Id. at *6-10.

Although the court's dismissal was without prejudice and provided plaintiffs with an opportunity to file a motion for leave to amend by September 17, 2013, the court specifically noted that if such a motion was not filed, "the court will enter final judgment in the case." Id. at *10. Plaintiffs subsequently sought an extension of time to file their motion by October 17, 2013, which was granted. After the extended deadline passed, on October 22, 2013, defendants moved to dismiss the case, which the court granted shortly thereafter. See Laborers' Local 265 Pension Fund v. iShares Trust, No. 3:13-cv-00046 (M.D. Tenn. Oct. 24, 2013).

2. The New Frontier: Manager of Managers Cases

In the so-called "manager of managers" cases, plaintiffs take aim at fund managers that rely on sub-advisers for the provision of investment advisory services, a practice that is particularly prevalent in the insurance industry. Plaintiffs in these actions generally assert that the sub-advisers are performing, with minor exceptions, all of the investment management services, but only

receive a "fraction" of the fee paid to the manager. These cases are the new frontier of Section 36(b) litigation.

a. In Curran v. Principal Management Corp., No. 4:09-cv-433, 2010 WL 2889752 (S.D. Iowa June 8, 2010), vacated in part by 2011 WL 223872 (S.D. Iowa Jan. 24, 2011), investors in two "funds of funds" (i.e., mutual funds that invest in other mutual funds), alleged that defendants violated Section 36(b) by charging excessive advisory fees, receiving excessive profits due to economies of scale, and with regard to excessive Rule 12b-1 fees (counts I, II and III, respectively). Notably, plaintiffs brought these claims on behalf of the funds in which they owned shares (i.e., the funds of funds), as well as the underlying funds in which those funds invested. The "funds of funds" and the underlying funds were all part of the Principal fund complex.

Plaintiffs also alleged that the defendant investment adviser relied on sub-advisers to provide investment advisory services to the funds, but still charged the funds a higher fee than what was paid to the sub-advisers. Notably, plaintiffs did not challenge the sub-advisers' fees, but instead contended those fees proved the excessiveness of the defendant investment adviser's fees. Id. at *8.

At the outset, defendants moved to dismiss plaintiffs' claims on the basis that they lacked statutory standing to assert the claims on behalf of the underlying funds. Id. at *2. While defendants pointed out that plaintiffs failed to allege ownership in the underlying funds, the court noted that plaintiffs were "affected by the fees paid to the investment advisor in the same way as people who directly own shares in the Underlying Funds." Id. at *4 & n.5. Thus, after analyzing the text of Section 36(b), the structure of the ICA, its legislative history, as well as relevant case law, the court concluded that Section 36(b) "creates a private right of action for all 'security holders' in the registered investment company, including persons who possess an interest in a mutual fund that is acquired through a fund of funds . . . ." Id. at *6; but see infra (vacating this portion of the decision).

The court next denied in part and granted in part defendants' motion to dismiss relating to excessive advisory fees. The court concluded that plaintiffs' allegations that the investment adviser "charges more than the subadvisors, who allegedly provide the bulk of investment advice, that the charges do not reflect the benefits derived from economies of scale, and that other institutional clients pay less for the same services, all support a reasonable inference that [the investment adviser] collected excessive fees for its investment advising services of the Subject

Funds," and denied defendants' motion to dismiss with regard to the investment adviser that actually received the challenged advisory fees. Curran, 2010 WL 2889752, at *9.

The court granted the motion to dismiss, however, with regard to the funds' distributor, as well as an affiliated investment adviser that was not adequately alleged to have been a recipient of the challenged compensation. Id. at *9-10.

Next, the court dismissed plaintiffs' second claim regarding defendants' alleged receipt of excessive profits from economies of scale. "Because the existence of 'excess profits from economies of scale' does not provide an alternative, independent basis for a § 36(b) claim, Count II will be dismissed." Id. at *10.

Finally, with regard to plaintiffs' Rule 12b-1 claim, the court stated that plaintiffs "have met their burden by alleging that fees collected by [the distributor] for its distribution services surpassed the value of those services, and that the manner in which those fees were assessed did not correspond to the type of services performed but, rather, resemble fees collected for advisory services." Id. at *11. Noting that defendants' arguments were largely factual in nature, the court concluded that "the allegations set forth in Count III are sufficient to raise an inference that the distribution fees collected by [the distributor] were additional and excessive compensation for advisory services subject to a § 36(b) claim." Id.

Defendants subsequently filed a motion for reconsideration with respect to the issue of statutory standing under Section 36(b) for the underlying funds. The court concluded that its prior interpretation of the relevant statutory language was clearly erroneous, and held that plaintiffs do not have a private right of action pursuant to Section 36(b) to assert claims on behalf of the eighteen underlying funds in which they did not hold any "securities." See Curran v. Principal Mgmt. Corp., LLC, No. 4:09-cv-433, 2011 WL 223872 (S.D. Iowa Jan. 24, 2011).

On May 17, 2013, the parties alerted the court that the surviving portion of the action had settled. The court approved the parties' settlement on June 12, 2013, and dismissed the action with prejudice.

b. In Santomenno v. John Hancock Life Insurance Co., 677 F.3d 178 (3d Cir. 2012), plaintiffs brought suit against defendants for allegedly charging excessive fees on annuity insurance contracts offered to plan participants through which participants could invest in certain mutual funds. Plaintiffs' Section 36(b) claims

challenged the structure of those mutual funds, as defendants utilized sub-advisers to provide investment advisory services to the funds. Plaintiffs alleged that defendants' management fees for the funds were excessive because they significantly exceeded the fees paid to the sub-advisers. The district court granted defendants' motion to dismiss on plaintiffs' Section 36(b) claim because plaintiffs "no longer owned any interest in the John Hancock funds." Id. at 181. The Third Circuit affirmed. Id.

The Third Circuit rejected plaintiffs' argument that there is no "continuing ownership requirement" under Section 36(b). The court noted that plaintiffs' "mistakenly assume that the root of the continuous ownership requirement is Rule 23.1. Instead, the prerequisite arises from the fact that Congress directed that only the Securities and Exchange Commission and securities holders, *acting on behalf of the investment company*, could bring an action to enforce the rights created by Section 36(b). As the Court recognized in Daily Income Fund, any recovery in an action brought under Section 36(b) belongs to the investment company. When a plaintiff disposes of his or her holdings in the company, that plaintiff no longer has a stake in the outcome of the litigation because any recovery would inure to the benefit of existing securities holders, not former ones. A continuous ownership requirement gives effect to this 'undeniably derivative' nature of a Section 36(b) claim." Id. at 184 (citations omitted) (emphasis in original).

c. In Sivolella v. AXA Equitable Life Insurance Co., No. 11-4194, 2012 WL 4464040 (D.N.J. Sept. 25, 2012), plaintiff was an investor in a variable annuity administered by defendants, which enabled plaintiff to invest in a variety of mutual funds managed by defendants. Plaintiff brought claims under, inter alia, Section 36(b) alleging that defendants' management fees were excessive because defendants utilized sub-advisers to provide investment advisory services to the funds, but still charged higher fees than the sub-advisers.

Under the variable annuity, plaintiff made payments to defendants, which were then segregated into a separate account controlled by defendants. The separate account then invested in AXA funds for the benefit of plaintiff. Notably, the AXA funds at issue were sold only to insurance companies and not to the general public. Accordingly, when plaintiff brought claims for a violation of Section 36(b) and unjust enrichment, defendants filed a motion to dismiss on the grounds that plaintiff lacked standing. Id. at *2, 4.

The court noted that defendants' position was that "the term 'security holder,' as used in Section 36(b), refers to the legal or record owner of a security" while plaintiff's position was that "the term refers to the equitable or beneficial owner of a security." Id. at *4.

The court began its analysis by noting that the Act was intended to protect the rights of mutual fund shareholders, and that the term "security holder" was not defined "in order to control situations regardless of the legal form or structure of the investment." Id. (citing Prudential Ins. Co. of Am. v. S.E.C., 326 F.3d 383, 386-88 (3d Cir. 1964)).

The court concluded "it seems to make little sense to broadly construe the word 'security,' and limit the reach of 'holders' to entities that lack any economic interest or stake in the transaction. Here, it would make no sense to limit standing to enforce ICA § 36(b) to AXA or any other entity that did not pay the allegedly excessive compensation [when] Plaintiff and similarly situated investors are responsible for and paid all of the challenged fees. Plaintiff and other investors bear the full risk of poor investment performance. Plaintiff and other investors have the right to instruct AXA how to vote their shares. Assets held in a separate account are immune from claims of AXA's creditors, while being vulnerable to claims of the investors' creditors. And when Plaintiff decides to withdraw her investment in the AXA Funds, she, not AXA, pays the taxes on that investment. Given that, Plaintiff has all of the economic stake in these transactions." Id. at *5 (citation omitted).

The court also rejected defendants' reliance on Curran v. Principal Management Corp., No. 433, 2011 WL 223872 (S.D. Iowa Jan. 24, 2011), which held that an investor in a "fund of funds" is not a "security holder" in the mutual funds invested in by the fund of funds. The court noted "that in Curran, plaintiffs did not have standing with respect to the underlying funds because they 'd[id] not enjoy any of the incidents of ownership or possession of any security in the Underlying Funds because they d[id] not have the privilege of voting, they d[id] not receive dividends and they d[id] not receive liquidations with regard to the Underlying Funds.' As previously stated, here, Plaintiff has the right to instruct AXA how to vote, dividends enhance the value of her investments, and when she withdraws her investment in the AXA Funds, she will receive

those proceeds, as well as any dividends." Sivolella, 2012 WL 4464040, at *5 (quoting Curran, 2011 WL 223872, at *4).[5]

Finally, the court dismissed plaintiff's federal common law unjust enrichment claim because "it is not needed to fill in the interstices of the ICA." Sivolella, 2012 WL 4464040, at *5. Subsequent to the motion to dismiss, the court also struck plaintiff's jury demand. Sivolella v. AXA Equitable Funds Mgmt. LLC, Nos. 11-4194, 13-312, 2013 WL 4096239 (D.N.J. July 3, 2013), adopted by, 2013 WL 4402331 (D.N.J. Aug. 15, 2013).

d. In Kasilag v. Hartford Investment Financial Services, LLC, No. 11-1083, 2012 WL 6568409 (D.N.J. Dec. 17, 2012) investors in six mutual funds alleged that defendant charged excessive investment management fees, as well as excessive Rule 12b-1 fees. With respect to plaintiffs' investment management fee claims, plaintiffs alleged that defendant's management fees were excessive because defendant hired sub-advisers to provide investment advisory services to the funds, but still charged higher management fees than the sub-advisers. Following a motion to dismiss plaintiffs' amended complaint, which was granted in part and denied in part with leave to amend, plaintiffs amended their complaint again. Defendant brought a motion to dismiss both counts of the second amended complaint. Id. at *2.

The court first credited plaintiffs' allegations relating to sub-advisory fees, noting that the complaint alleged that defendant paid sub-advisers to perform substantially all of the services provided to the funds, "at a fraction of the fee [defendant] charges for such services." Id. at *3. The court noted that while this count had been previously dismissed for lack of specificity, the revised complaint added allegations regarding the overlap of services

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[5] But see SSR II, LLC v. John Hancock Life Ins. Co. (U.S.A.), No. 652793/2011, 2012 WL 4513354 (N.Y. Sup. Ct. Sept. 28, 2012). In this case, an investor in numerous variable life insurance policies chose to invest in a fund ("the underlying fund") that *then* invested in funds that fed into Bernard Madoff's ponzi-scheme. When the investor brought various state claims against the insurance carriers and investment advisers of the underlying fund, the court dismissed several of plaintiff's claims for lack of standing. The court began by noting that it was undisputed that the insurance carriers invested in the underlying fund on behalf of plaintiff "to ensure that the cash value of [plaintiff's] variable life insurance policies could earn investment returns without incurring income taxes." Id. at *2. The court then reasoned that plaintiff could not assert derivative claims on behalf of the underlying fund because plaintiff "is not a partner or investor and has no other type of relation to the [underlying fund] that would permit it to act on behalf of the Fund. In fact, although [plaintiff] seeks to be considered an 'investor,' in the past, it has held itself out *not* to be an 'investor' for [tax] purposes. . . . [Plaintiff] cannot now maintain that it is an investor to avail itself of derivative claims that properly vest in the legal investors (the Carriers)." Id. at *3 (emphasis in original).

provided by defendant and sub-advisers under the respective agreements, as well as the differences in the fees charged. Id.

The court also rejected defendant's arguments concerning the complaint's comparisons to fees charged by: (1) Vanguard; and (2) by defendant's affiliate to institutional accounts. Id. at *4-5. With respect to the first argument, the court noted that while comparisons to Vanguard are typically of little use in a Section 36(b) case, that such a comparison "is more apt" here because Vanguard and defendant employ the same sub-adviser. The court thus took note that the complaint alleged that investors "in the Funds receive comparable investment management services to the Vanguard funds but pay substantially greater fees." Id. at *5. The court also found defendant's second argument unavailing because plaintiffs alleged that an "apples-to-apples" comparison was possible between retail and institutional clients. This was due to the fact that plaintiffs had also alleged that any services that were only provided to retail funds were provided pursuant to "separate agreements . . . that set them apart from the institutional clients." Id. Significantly, however, the court limited the reach of plaintiffs' institutional fee allegations to the only retail fund that plaintiffs compared to other specific institutional funds. Id.

The court granted without prejudice, however, defendant's motion to dismiss regarding Rule 12b-1 fees. The court based its dismissal on the complaint's "sparse and conclusory" allegations, as well as plaintiffs' failure to establish standing with respect to Class B shares of the funds. Id. at *8-9.

3. Former Revenue Sharing Class Actions Repleaded As Excessive Management Fee Claims

a. In In re American Mutual Funds Fee Litigation, following more than two years of extensive fact and expert discovery, a Section 36(b) case was tried on the merits for the first time in 20 years. The case was tried from July 28, 2009 through August 7, 2009, before Judge Feess in the Central District of California. The plaintiffs' excessive fee claim was directed at eight of the 30 funds in the American Fund complex. Sixteen witness testified at trial: 11 fact witnesses and five experts. One of the principle theories advanced by plaintiffs at trial was that the eight funds had experienced significant growth in assets under management during the period 2003-2008, and that such growth negatively impacted the investment results of those funds. Plaintiffs claimed, among other things, that, as a result of this negative impact, Rule 12b-1 fees, which contributed to the growth of the funds, were excessive. Plaintiffs also attacked investment advisory, transfer agent, and

administrative service fees as excessive. After receiving post-trial briefing, Judge Feess entertained "closing" arguments on September 2, 2009.

Thereafter, the court announced its "intended decision," finding that plaintiffs failed to meet their burden of establishing that the fees in question were so disproportionate to the services rendered that they could not have been the result of arm's-length bargaining. With respect to plaintiffs' claim regarding 12b-1 fees, the court indicated that plaintiffs' theory spoke only to the use of such fees, and that plaintiffs failed to adduce evidence establishing that the nature and quality of the services provided in exchange for those fees was disproportionate. In addition, the court found that plaintiffs failed to establish that the growth in assets under management had any negative impact on investment results. Judge Fees also refused to apply the standards articulated by the Seventh Circuit in Jones and the Eight Circuit in Gallus, finding that both were inconsistent with Section 36(b) itself. Judge Feess found that the proper standard was that articulated in Gartenberg and its progeny. At the directive of Judge Fees, the Defendants submitted post-trial proposed findings of fact and conclusions of law on October 2, 2009.

On December 28, 2009, Judge Feess issued a 105-page opinion, containing extensive Findings of Fact and Conclusions of Law that echoed, in large part, the holdings included in his prior "intended decision." In doing so, Judge Feess rejected each of the plaintiffs' principal theories of liability and ruled for defendants on all of the major substantive issues presented, including the standard for liability under Section 36(b) and each of the Gartenberg factors. See In re Am. Mutual Funds Fee Litig., No. CV 04-5593, 2009 WL 5215755 (C.D. Cal. Dec. 28, 2009).

As an initial matter, the court found that "the proper legal standard to be applied to Plaintiffs' excessive fee claims under Section 36(b) is the standard set forth in Gartenberg," and squarely rejected the alternative standards set forth in both Jones v. Harris, 527 F.3d 627 (7th Cir. 2008), and Gallus v. Ameriprise, 561 F.3d 816 (8th Cir. 2009). See In re Am. Mutual Funds Fee Litig., 2009 WL 5215755, at *43. However, the Court found that "Section 36(b) does not require Plaintiffs' to establish that the fees charged by Defendants were excessive in the aggregate. Plaintiffs may challenge a particular fee and may prevail on their Section 36(b) claim if they can show that such a fee was disproportionate to the services rendered in exchange for that fee." See In re Am. Mutual Funds Fee Litig., 2009 WL 5215755, at *44.

Next, the court addressed the nature and quality of services provided to the funds and their corresponding shareholders, noting that the "long-term performance of the majority of the funds at issue ranged from good to excellent in five-year, ten-year, and lifetime intervals," and the "Funds' very high shareholder retention rates and low level of complaints are consistent with shareholder satisfaction with the level of services provided." Id. at *18, 48. As a result, the court found that the plaintiffs failed to offer any evidence undermining the conclusion that defendants' investment advisory services were anything other than of the highest quality. See id. at *49.

With respect to profitability, the court found that defendants overall "profit levels" ranged from pre-tax operating margins of 30% to 35%, which "fall within the range of profit margins that other courts have deemed acceptable under Section 36(b)" Id. at *50. As to economies of scale, the court began its analysis by noting that the existence of scale is "properly analyzed at the fund complex level and not at the fund level." Id. at *28. After finding that economies of scale can be shared with fund shareholders in a number of ways, including breakpoints, fee reductions, fee waivers, offering low fees from inception, or making additional investments to enhance shareholder services, the court held that plaintiffs had "failed to sustain their burden of proving the existence of economies of scale" and "any economies of scale that may have been realized during the relevant period were sufficiently shared with investors." Id. at *51, 52 (internal citations omitted).

According to the court, the independent directors of the American Funds were "successful, well-educated business people with knowledge regarding financial markets and financial services," were "well-qualified with significant experience relevant to the performance of their duties," and were given "extensive" and "comprehensive" materials which "provided sufficient factual detail and explanatory background to allow [them] to fulfill their responsibilities to Fund Shareholders." Id. at *31, 53, 54. Although the independent directors "did not diligently inquire into some issues of importance and failed to recognize the consequence of some of the information presented to them," the court nevertheless held that overall the conduct of the directors met the Gartenberg standard. Thus, the court concluded, based on the entirety of the record before it, that the independent directors diligently exercised their responsibility in approving the fees at issue. See In re Am. Mutual Funds Fee Litig., 2009 WL 5215755, at *55-56.

As indicated in its "intended decision," the court found that plaintiffs failed to establish the growth in assets under management had any negative impact on investment results. Indeed, to the contrary, the court held that the growth of the American Funds during the 2003 through 2008 time-period actually "benefited the Funds in a number of ways." Id. at *14. For example, "the fees paid by the Funds declined (in percentage terms) as a result of growth via breakpoints, waivers, and reductions in the other fees charged to the Funds." Id. Moreover, the court concluded that "the size of the Funds has [also] led to lower brokerage commissions, enhanced [Capital Research]'s competitive advantage in trading, and led to better service from trading partners," (id.) and "[t]here was no persuasive evidence demonstrating that the size and growth of the funds negatively impacted the Funds' performance" Id. at *16. Indeed, the court found that "[s]ome of the Funds best investment results came during the period when the Funds were at their largest, and some of the largest and fastest growing funds were among the best performing." Id.

Finally, the court concluded that defendants' fees were lower than industry averages for comparable funds, and that plaintiffs adduced no evidence that defendants had realized any so-called fallout benefits. See id. at *53. As a result, plaintiffs "failed to sustain their burden of proving that [Capital Research] charged fees that were 'so disproportionally large that [they bore] no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining'" and entered judgment for defendants. Id.

When plaintiffs appealed Judge Feess's decision, the Ninth Circuit affirmed the ruling "in large part for the reasons stated in the district court's comprehensive order." Jelinek v. Capital Research & Mgmt. Co., 448 F. App'x 716 (9th Cir. 2011).

b. In In re Salomon Smith Barney Mutual Fund Fees Litigation, 441 F. Supp. 2d 579 (S.D.N.Y. 2006), another revenue sharing action, plaintiffs alleged that Salomon Smith Barney ("SSB") and certain affiliated entities engaged in a scheme consisting of three components: (1) SSB offered undisclosed incentives to brokers and financial advisers to steer investors into SSB's proprietary funds and other funds with which SSB had undisclosed "kickback" arrangements; (2) SSB extracted improper fees from investors in its proprietary funds; and (3) SSB caused its proprietary funds to invest in poorly performing companies because of their status as SSB investment banking clients. See id. at 583-85. Plaintiffs asserted claims under Sections 11, 12(a)(2), and 15 of the

Securities Act of 1933; Sections 10(b) and 20(a) and Rules 10b-5 and 10b-10 of the Securities Exchange Act of 1934; Sections 34(b), 36(b), and 48(a) of the Act; and various claims under state law. Defendants moved to dismiss the complaint in its entirety including plaintiffs' Section 36(b) claim, arguing, inter alia, that the claim was improperly asserted directly as a putative class action rather than derivatively on behalf of the subject funds and that plaintiffs' Section 36(b) allegations were insufficient to state a claim.

Judge Crotty agreed, and dismissed plaintiffs' Section 36(b) cause of action. The court first addressed defendants' argument that a Section 36(b) claim may only be properly asserted derivatively on behalf of the funds rather than directly by fund shareholders. Distinguishing the Supreme Court's decisions in Fox and Kamen as dealing with the applicability of the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure, the court held that Section 36(b) confers a derivative, and not a direct, right of action and dismissed plaintiffs' claim accordingly. See id. at 593-97. Moreover, the court also found that the allegations in the complaint were insufficient to state a claim under Section 36(b). First, plaintiffs' allegations regarding improper Rule 12b-1 fees, soft dollars, and commissions fell outside the scope of Section 36(b), which covers only the receipt of compensation by investment advisers and their affiliates, not compensation paid to brokers and other third parties. Id. at 600-01. Second, absent any allegation that the total fees charged were disproportionate to the services provided, plaintiffs' allegations regarding the improper use of fees charged to the funds were insufficient to state a claim under Section 36(b). Id. at 601-03 (citing In re Eaton Vance Mutual Funds Fee Litig., 403 F. Supp. 2d 310 (S.D.N.Y. 2005)). The court granted plaintiffs leave to replead the Section 36(b) claims as a derivative claim and advised plaintiffs to be mindful of the pleading standards of Section 36(b) and Gartenberg in doing so. See Salomon Smith Barney, 441 F. Supp. 2d at 603.

In response to Judge Crotty's July 26, 2006 decision, plaintiffs filed a Second Consolidated Amended Complaint on behalf of nine individual SSB mutual funds, alleging violations of Section 36(b) of the Act. Defendants again moved to dismiss, arguing that plaintiffs' allegations in support of their Section 36(b) claim failed to state a cause of action. The court agreed. Citing the Second Circuit's opinion in Amron v. Morgan Stanley Investment Advisors, Inc., 464 F.3d 338 (2d Cir. 2006), Judge Crotty noted that, in order to survive dismissal at the initial pleading stage, a plaintiff must set forth those facts necessary to a finding that the fees were excessive, on a factor-by-factor basis. See Salomon

Smith Barney, 528 F. Supp. 2d 332, 337 (S.D.N.Y. 2007). Prior to conducting its own analysis of the allegations set forth by plaintiffs, the court noted that Judge Sweet, in a substantially similar case, applied the analysis employed by the Second Circuit in Amron and found the allegations insufficient to withstand dismissal. See id. at 337 n.7. The court next conducted a factor-by-factor analysis of the allegations contained in the Second Consolidated Amended Complaint and, relying on the Second Circuit's decision in Amron, held that plaintiffs "failed to allege sufficient facts to support any of the Gartenberg factors." Id. at 339. Moreover, the court noted that during the course of oral argument on defendants' motion to dismiss, "[p]laintiffs' counsel conceded that he could not identify any case in the Second Circuit or Southern District of New York where allegations [of improper revenue sharing resulting in excessive fees] have satisfied" the standard adopted by Gartenberg and reaffirmed by Amron. The court dismissed the complaint in its entirety, with prejudice. Id. Plaintiffs appealed the court's dismissal to the Second Circuit, which heard oral argument in the matter in March 2009.

The Second Circuit noted that dismissal was warranted with regard to most of plaintiffs' Section 36(b) claims, but reversed the district court with regard to plaintiffs' transfer agent fees claim. Plaintiffs alleged that SSB caused the funds to replace its transfer agent with an SSB affiliate. "Once it replaced the existing agent, the SSB affiliate then sub-contracted with that agent to continue to perform virtually the same services that it had previously performed, but at a steep discount. Rather than pass the resulting savings on to investors in the form of lower fees, SSB's affiliate kept the windfall, permitting Defendants to profit at the expense of the SSB Funds and their investors." R.W. Grand Lodge of F. & A. M. of Pa. v. Salomon Bros. All Cap Value Fund, 425 F. App'x 25, 30 (2d Cir. 2011).

The court noted that plaintiffs' claim "constitutes a garden variety breach of fiduciary duty. We recently considered similar allegations in a case argued in tandem with this one, and involving some of the same defendants [and] determined that, as a result of the alleged transfer agent arrangement, the 'shareholders were being grossly overcharged for transfer agent services and [the investment adviser] was reaping the benefits.' In effect, 'the Fund investors . . . were at the mercy of a faithless fiduciary.' We have little trouble concluding that, as alleged, transfer agent services fees resulting from this particular arrangement bear no reasonable relationship to the services rendered, could not have been the product of arm's length bargaining, and as a result, adequately support an alleged violation of section 36(b)." Id. at 30-31

(quoting Operating Local 649 Annuity Trust Fund. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 93 (2d Cir. 2010)).

C. Attempts to Expand the Scope of Section 36(b)

In the last decade, the "themes" pursued by plaintiffs changed. In addition to alleging that an adviser's fees are "excessive," plaintiffs now invoke Section 36(b) to challenge fund distribution and trading practices, failure to participate in class action settlements in connection with portfolio securities, and the adviser's portfolio selections for the fund. Plaintiffs also are attacking the structure of the fees themselves as *per se* violations of Section 36(b), without necessarily alleging that they are excessive or disproportionate to the services rendered.

There were approximately 25 of the "revenue sharing" cases pending in federal courts around the nation. Those cases, along with the Settlement Participation Class Actions, are attempts by the plaintiffs' bar to expand the scope of Section 36(b). In contrast to the "pure" excessive management fee actions, courts have issued many more decisions in the revenue sharing line of cases—all since August 1, 2005. There have also been numerous decisions involving the Settlement Participation Class Actions.

More recently, the Supreme Court's decision in Jones, et al. v. Harris Associates, L.P. potentially closes the door on plaintiffs' attempts to expand Section 36(b) beyond pure excessive fee claims.

1. Distribution Practices—Directed Brokerage, Revenue Sharing, and Rule 12b-1 Plans

Directed Brokerage & Revenue Sharing

a. In In re Lord Abbett Mutual Funds Fee Litigation, 385 F. Supp. 2d 471 (D.N.J.), amended and superseded by 407 F. Supp. 2d 616 (D.N.J. 2005), plaintiffs asserted class and derivative claims alleging that brokers were compensated excessively as an incentive for them to steer new investors into Lord Abbett mutual funds. Plaintiffs alleged broker compensation was excessive because it included, above the standard compensation for executing portfolio transactions and selling shares, either revenue sharing payments or soft dollar payments. The adviser also allegedly treated brokers to lavish vacations and directed brokerage business to brokers who steered clients into Lord Abbett Funds. See In re Lord Abbett, 385 F. Supp. 2d at 475-76. Plaintiff purported to bring, inter alia, a direct claim for breach of fiduciary duty under Section 36(b).

The court sua sponte concluded that a Section 36(b) claim can be maintained only as a derivative, rather than a direct claim, and accordingly dismissed plaintiffs' direct Section 36(b) class action claim. In re Lord Abbett, 385 F. Supp. 2d at 488. In so holding, Judge Martini cited the Supreme Court's decision in Daily Income

Fund, Inc. v. Fox, 464 U.S. 523, 535 n.11 (1984), which stated "unequivocally" that Section 36(b) confers only a derivative right of action. The court noted that the Supreme Court's decision in Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 108 (1991), does not alter this conclusion, finding that when examined in context, Kamen merely states that a shareholder may bring a derivative claim under Section 36(b) without making a pre-complaint demand; that suit, however, remains a derivative action brought on behalf of the company. In re Lord Abbett, 385 F. Supp. 2d at 488 n.6. The court dismissed the Section 36(b) claim without prejudice.

Plaintiffs moved for reconsideration, arguing that the court's holding is contrary to Supreme Court precedent, and ignored Section 36(b)'s supposed distinction between claims by shareholders and claims by the fund. Explaining that he previously considered and rejected precisely these arguments in his decision on defendants' motion to dismiss, Judge Martini denied plaintiffs' motion. In re Lord Abbett Mutual Funds Fee Litig., 417 F. Supp. 2d 624 (D.N.J. 2005).

Although Judge Martini had previously provided plaintiffs with leave to amend the complaint to assert a Section 36(b) claim derivatively, the Lord Abbett Defendants moved for reconsideration, arguing that the court's previous decision dismissing state law claims as preempted under SLUSA required dismissal with prejudice of the action in toto. See In re Lord Abbett Mutual Funds Fee Litig., 463 F. Supp. 2d 505, 509 (D.N.J. 2006). Judge Martini agreed, finding that the plain language of SLUSA required dismissal of the entire "covered class action" rather than mere "counts," "claims," or "allegations." The court noted that such an interpretation was consistent with the Supreme Court's recent decision in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503 (2006), which recognized that Congress intended SLUSA's preemptive powers to be broadly construed. See In re Lord Abbett, 463 F. Supp. 2d at 513-14. Because the use of the phrase "covered class action" required dismissal of the entire class action, including plaintiffs' Section 36(b) claim, the court held that the previous dismissal of the Section 36(b) claim had to be with prejudice. Id. at 515.

Plaintiffs appealed Judge Martini's decision. In a case of first impression, the Third Circuit reversed and remanded for further proceedings. See In re Lord Abbett Mutual Funds Fee Litigation, 553 F.3d 248 (3d Cir. 2009). The court held that the word "action" in the language of SLUSA is modified by the phrase "based upon the statutory or common law of any State." Id. at 255. As such,

and in light of the legislative history of SLUSA, the court held that SLUSA does not mandate dismissal of an action in its entirety where the action includes only some "pre-empted" claims. Id. at 255-56.

b. In In re Goldman Sachs Mutual Funds Fee Litigation, No. 04 Civ. 2567, 2006 WL 126772 (S.D.N.Y. Jan. 17, 2006), plaintiffs brought claims under Section 34(b), 36(a), 36(b), and 48(a) of the Act and Sections 206 and 216 of the Investment Advisers Act of 1940, as well as state law claims for breach of fiduciary duty and unjust enrichment. Plaintiffs alleged that defendants charged the Goldman Sachs Funds' shareholders excessive fees, which were then used to pay kickbacks to brokerage firms to steer new investors into the Funds. Plaintiffs further alleged that the existing shareholders received no benefit from the economies of scale that theoretically should have resulted from the increased assets in the funds. Id. at *1-4.

Judge Buchwald dismissed the Section 36(b) claim in its entirety. At the outset, Judge Buchwald held that plaintiffs failed to allege that the "Trustee/Officer Defendants" actually received investment advisory or Rule 12b-1 fees. The court rejected plaintiffs' argument that the Trustee/Officer Defendants violated Section 36(b) by receiving their compensation despite the fact that they violated their fiduciary duties. Judge Buchwald found that this allegation did not meet the requirements of Section 36(b) because this compensation does not constitute receipt of payments for advisory services or Rule 12b-1 fees. Id. at *7-8.

With respect to the other defendants, the court held that plaintiffs failed to allege facts demonstrating the lack of any reasonable relationship between fees received and services provided by the distributor and adviser defendants. Judge Buchwald concluded that plaintiffs failed to allege that either the advisory fees or Rule 12b-1 fees were disproportionate to the services rendered, as required by Section 36(b). The court noted that plaintiffs' allegations regarding Rule 12b-1 fees could not establish that the advisory fees were excessive, and that mere assertions that fees increased with the size of the funds could not establish that benefits from economies of scale were not passed on to investors. In addition, merely asserting that Rule 12b-1 fees were charged while the funds at issue were closed to new investors did not adequately allege that the fees charged were disproportionate to the services rendered. Finally, the court held that the kickback allegations did not constitute support for the excessive Rule 12b-1 allegations. Id. 8-10. Judge Buchwald dismissed the Section 36(b) claim in its entirety.

c. In Forsythe v. Sun Life Financial, Inc., 417 F. Supp. 2d 100 (D. Mass. 2006), plaintiffs alleged that defendants made substantial payments to brokers in exchange for the brokers' steering unwitting clients to invest in funds in the Massachusetts Financial Services ("MFS") family of funds. Defendants moved to dismiss the complaint in its entirety.

Judge O'Toole held that plaintiffs stated a claim under Section 36(b). After reviewing the Gartenberg factors and noting that the First Circuit has not expressly adopted these factors, Judge O'Toole opined that Gartenberg does not establish a heightened pleading standard for Section 36(b) claims and that plaintiffs' failure to plead facts that specifically address the Gartenberg factors was not in itself a ground for dismissal. See Forsythe, 417 F. Supp. 2d at 114.

Judge O'Toole found that defendants were correct that plaintiffs must allege some connection between the wrongs alleged and excessive compensation of an investment adviser or affiliated persons. However, the court was unwilling to conclude at the motion to dismiss stage that a Section 36(b) claim may not attack the lawfulness of excessive Rule 12b-1 fees, soft dollar payments, and excessive broker commissions despite the fact that such payments may not be "advisory fees" in the most literal sense. The court concluded that plaintiffs satisfied the notice pleading requirements of Fed. R. Civ. P. 8 by alleging in some factual detail wrongful conduct specific to defendants. See id. at 115-16.

Judge O'Toole also rejected defendants' argument that the claim should be dismissed because plaintiffs failed to allege sufficient facts that, if proven, would demonstrate that the services rendered by defendants were disproportionate to the fees charged. While plaintiffs did not make any allegations regarding the quality of services rendered, the court found that such allegations may be irrelevant to their theory of excessiveness. Plaintiffs' theory was that the fees were excessive because they were unauthorized and taken from fund assets solely for the defendants' benefit; in other words, fees amounting to "something for nothing" are inherently excessive. Judge O'Toole noted that at least one court in a different Section 36(b) context concluded that the wrongful retention of monies by an adviser that were in essence "something for nothing" could represent a disproportionate relationship between fees and services. See Forsythe, 417 F. Supp. 2d at 116 (citing Jones v. Harris Assocs. L.P., Civ. No. 04 C 8305, 2005 WL 831301, at *3 (N.D. Ill. Apr. 7, 2005)).

The court did, however, find that plaintiffs' Section 36(b) claim improperly claimed damages for a greater period than is allowed by the statute, and appeared to claim damages against the trustee defendants, who were not proper defendants under the statute. The surviving Section 36(b) claim was limited accordingly. See Forsythe, 417 F. Supp. 2d at 116-17.

Judge O'Toole also held that plaintiffs lacked standing to assert any Section 36(b) claim except on behalf of the two funds in which they owned shares at the time the lawsuit was filed, and dismissed the claim against the rest of the funds. Judge O'Toole stated that this conclusion followed not only from the plain statutory language, but also from the unique nature of the Section 36(b) cause of action. The court rejected plaintiffs' argument that they had standing to sue because the MFS Funds allegedly engaged in a common course of wrongful conduct. Judge O'Toole stated that each fund should be treated as a separate and distinct entity in the Section 36(b) context and a plaintiff may not use the corporate structure of the broader investment company to confer standing. The court concluded that plaintiffs may not use a class action to bootstrap themselves into standing that they lack. See Forsythe, 417 F. Supp. 2d at 117-18.

Following Judge O'Toole's decision denying defendants' motion to dismiss plaintiffs' Section 36(b) claim, defendants' filed a motion for a protective order in an effort to secure a decision declaring that the damages period applicable to Section 36(b) claims was limited to only the one year period before the filing of the complaint. See Forsythe v. Sun Life Fin., Inc., 475 F. Supp. 2d 122 (D. Mass. 2007). Plaintiffs opposed defendants' motion, arguing that the period for which damages may be awarded under Section 36(b) begins one year before the filing of the complaint and continues until the complaint is fully adjudicated and that, even if the court were to limit damages to those accruing within the one year period prior to the commencement of the lawsuit, discovery should not necessarily be limited to events occurring within that limited period. See id. at 123-24. In support of their position, defendants' cited numerous cases, including the Supreme Court's decision in Daily Income Fund v. Fox, 464 U.S. 523, 526 n.2 (1984). After briefly addressing each of the cases cited by defendants in turn, the court noted that, with the sole exception of a lone order by a magistrate judge, "[i]n all of these cases, the courts were considering the effect of § 36(b)(3)'s backward-looking limitation, and not whether that section imposed a forward-looking one." Forsythe, 475 F. Supp. 2d at 127. With respect to Daily Income, the court found that "the Court's brief reference to the damages period was casual dictum, not a controlling holding," and

concluded that Section 36(b)(3) permits ongoing damages on a forward-looking basis. Id. at 128. Accordingly, the court denied defendants' motion for a protective order.

d. In In re Oppenheimer Funds Fees Litigation, 419 F. Supp. 2d 593 (S.D.N.Y. 2006), another revenue sharing action, plaintiffs were shareholders in 23 Oppenheimer-branded mutual funds managed by OppenheimerFunds, Inc. and its affiliate, OppenheimerFunds Services. Plaintiffs alleged a variety of class and derivative claims against the parent corporation, investment advisers, distributors, and a select group of trustees, directors and officers of the Oppenheimer Funds. The crux of plaintiffs' complaint was a fraudulent scheme whereby the defendants made "improper secret payments" from fund assets to unaffiliated broker-dealers in an effort to induce those broker-dealers to push Oppenheimer Funds "more aggressively" to consumers, the result of which benefited the defendants at the expense of the Oppenheimer Funds. Plaintiffs also alleged that investment advisers improperly inflated their own fees in an effort to finance these payments and failed to pass onto Oppenheimer Fund shareholders the benefits of scale economies resulting from the increases in Fund assets. Plaintiffs asserted claims under Sections 34(b), 36(a), 36(b) and 48(a) of the Act; Sections 206 and 208 of the Investment Advisers Act of 1940; and state common law claims for breach of fiduciary duty and unjust enrichment. Defendants moved to dismiss the complaint in its entirety arguing, inter alia, that: (1) there is no private right of action under Sections 34(b), 36(a), and 48(a) of the Act; (2) plaintiffs' state common law claims were improperly brought directly as a putative class action and should have been asserted derivatively on behalf of the subject funds; (3) plaintiffs failed to make pre-suit demand or, alternatively, failed to plead futility with the requisite particularly for those claims brought derivatively pursuant to the Investment Advisers Act of 1940; and (4) plaintiffs failed to state a claim under Section 36(b) of the Act.

Although the court granted defendants' motion to dismiss with respect to the overwhelming majority of claims, it did sustain plaintiffs' Section 36(b) cause of action, finding that plaintiffs' allegations that defendants inflated their fees "so as to provide a slush fund for making some of the illicit payments" to unaffiliated broker-dealers "barely" survived the minimal pleading requirements of Fed. R. Civ. P. 8(a), despite the fact that the allegations were "poorly pled." Id. at 596-97 (citing Paragraph 220 of Amended Complaint). The court did, however, dismiss the Section 36(b) claim with respect to all defendants except the investment advisers, noting that only the investment advisers were

recipients of advisory compensation, as required by the Act. See id. at 597.

The investment adviser defendants moved for reconsideration of the court's opinion with respect to Section 36(b), arguing that the court's conclusion that paragraph 220 of the amended complaint supported a claim overlooked the fact that the theory as to why the subject fees were "excessive" was not one permitted by law. Specifically, defendants argued that the only allegation in the amended complaint pertaining to the "excessiveness" of the fees at issue involved plaintiffs' contention that increases in advisory fees were used to create a "slush fund to bribe brokers for the benefit of the investment advisers and their affiliates," and were not for the benefit of Oppenheimer Fund shareholders. Defendants claimed that plaintiffs were, in essence, advocating for a determination that such fees were *per se* "excessive," in violation of Section 36(b). The court agreed, noting that plaintiffs had failed to make any specific factual allegation, as required by Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), as to why the added amounts rendered the advisory fees disproportionate to the services rendered. See In re Oppenheimer Funds Fee Litig., 426 F. Supp. 2d 157, 158-59 (S.D.N.Y. 2006). The court vacated its previous ruling sustaining plaintiffs' Section 36(b) claim against the investment adviser defendants and dismissed, with prejudice, the remaining claim. See id. at 159.

e. In In re BlackRock Mutual Funds Fee Litigation, No. 04 Civ. 164, 2006 WL 4683167 (W.D. Pa. Mar. 29, 2006), plaintiffs similarly alleged that defendant BlackRock, Inc., and certain of its subsidiaries and affiliates, made improper "shelf-space" payments to unaffiliated broker-dealers in exchange for "aggressively" marketing BlackRock-branded mutual funds to "unwitting investors." According to plaintiffs, these improper payments were in several different forms, and included: (1) directed brokerage; (2) revenue sharing; and (3) so-called "soft-dollar" payments. Plaintiffs alleged that these payments violated: (1) Sections 34(b), 36(a), 36(b) and 48(a) of the ICA; (2) Section 215 of the Investment Advisers Act of 1940; and (3) state common law, including breach of fiduciary duty, aiding and abetting breach of fiduciary duty, unjust enrichment, and claims for anticompetitive conduct.

Defendants moved to dismiss the complaint in its entirety, including plaintiffs' Section 36(b) claim. According to defendants, the Section 36(b) claim was improperly brought directly as a putative class action, rather than derivatively on behalf of the subject funds. The court agreed with defendants, and dismissed

plaintiffs' Section 36(b) claim. See id. at *9-10. Citing the plain language of the statute and the Supreme Court's decisions in Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984) and Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991), the court held that Section 36(b) confers a derivative, and not a direct, right of action even though such an action is not subject to the demand requirement of Rule 23.1. See BlackRock, 2006 WL 4683167, at *9-10.

f. In In re Evergreen Mutual Funds Fee Litigation, 423 F. Supp. 2d 249 (S.D.N.Y. 2006), plaintiffs alleged that defendants engaged in a purported "kickback scheme" whereby they made undisclosed and improper payments to unaffiliated broker-dealers in an effort to induce these brokers to steer unwitting investors into Evergreen-branded mutual funds. Plaintiffs further alleged that the addition of new investors resulted in a marked increase in fund assets, the benefits of which were improperly retained by the investment adviser and its affiliates, and not passed on to fund shareholders. Based upon these allegations, plaintiffs brought the following claims against the investment adviser, distributor, trustees, officers, and other affiliates of the Evergreen family of mutual funds: (1) Sections 34(b), 36(a), 36(b) and 48(a) of the Act; (2) Section 215 of the Investment Advisers Act of 1940; and (3) a myriad of state common law claims, including breach of fiduciary duty, aiding and abetting breach of fiduciary duty, unjust enrichment, and claims for anticompetitive conduct. Defendants moved to dismiss plaintiffs' complaint in its entirely, including plaintiffs' Section 36(b) claim, arguing that: (1) the conduct at issue was not actionable under Section 36(b); and (2) plaintiffs failed to plead facts evidencing that the fees at issue were "excessive." See id. at 257.

Judge Sweet agreed and dismissed plaintiffs' Section 36(b) claim in its entirety. Citing the Second Circuit's decision in Gartenberg, the court concluded that a plaintiff asserting a claim under Section 36(b) must allege some facts demonstrating that the fees at issue are so disproportionately large that they bear no reasonable relationship to the services rendered. Noting that the allegations contained in the complaint were substantially similar to those at issue in both In re Eaton Vance Mutual Funds Fee Litigation and In re Goldman Sachs Mutual Funds Fee Litigation, Judge Sweet held that plaintiffs' allegations of revenue sharing were insufficient to sustain a claim under Section 36(b) because the complained of conduct related to the improper use of the subject fees, not that the fees themselves were excessive. See Evergreen, 423 F. Supp. 2d at 257-59. Moreover, the court dismissed the Section 36(b) claim with respect to the distributor defendant and trustees/officers for

the additional reason that the complaint failed to allege that those defendants were recipients of compensation, as required by Section 36(b)(3). See id. at 259.

In response to Judge Sweet's March 27, 2006 dismissal of plaintiffs' Section 36(b) claim, plaintiffs moved to set aside the court's previous order or, alternatively, for leave to file a second amended complaint in an effort to cure the deficiencies in their previous complaint. See In re Evergreen Mutual Funds Fee Litig., 240 F.R.D. 115 (S.D.N.Y. 2007). After briefly reviewing the standards applicable to a motion for reconsideration, the court found that it had not overlooked plaintiffs' prior allegations relating to economies of scale and the purported increase in management fees allegedly used to subsidize the adviser's improper payments to unaffiliated broker-dealers. The court, therefore, denied plaintiffs motion for reconsideration, noting that plaintiffs had failed to demonstrate, as a threshold requirement, the existence of allegations that were not previously considered by the court. See id. at 117-20.

The court then rejected plaintiffs' motion for leave to file yet another amended complaint, finding that further attempts to replead their Section 36(b) claim would be futile. See id. at 119-22. Citing Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), the court analyzed each of the six relevant factors in turn, and concluded that plaintiffs' proposed second amended complaint continued to suffer from material pleading deficiencies, and affirmed its earlier ruling dismissing the complaint in its entirety.

g. In In re Morgan Stanley & Van Kampen Mutual Fund Securities Litigation, No. 03 Civ. 8208, 2006 WL 1008138 (S.D.N.Y. Apr. 18, 2006), plaintiffs brought a myriad of claims relating to Morgan Stanley's revenue sharing program. According to plaintiffs, Morgan Stanley provided incentives to its sales force of individual registered representatives to promote the sales of its proprietary funds. Plaintiffs claimed that these sales incentives and Morgan Stanley's failure to disclose them constituted violations of Sections 11, 12 and 15 of the Securities Act of 1933; Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934; Sections 34(b), 36(b), and 48(a) of the Act; Sections 206 and 215 of the Investment Advisers Act of 1940, as well as state law claims for breach of fiduciary duty. With respect to plaintiffs' Section 36(b) claim, plaintiffs alleged that defendants purported use of improper Rule 12b-1 distribution fees, soft dollars, and the payment of "excessive commissions" by the investment advisers rendered defendants advisory fees "excessive" in violation of

Section 36(b). The court disagreed, noting that the Second Circuit's decision in Gartenberg provided six factors courts should consider when determining whether the advisory fees at issue are "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" and found that plaintiff's allegations pertaining to expense ratios and use of soft-dollars were "too vague and conclusory to meet the requirements of Gartenberg." Id. at *12. Citing Judge Koeltl's decision in Eaton Vance, the court found that plaintiffs' allegations fell outside the applicable scope of Section 36(b), "which addresses only the negotiation and enforcement of payment arrangements between investment advisers and funds, not whether investment advisers acted improperly in the use of the funds" and dismissed plaintiffs' Section 36(b) claim in its entirety. Id. at *13.

h. In In re Merrill Lynch Investment Management Funds Securities Litigation, 434 F. Supp. 2d 233 (S.D.N.Y. 2006), plaintiffs alleged that Merrill Lynch and related defendants entered into agreements with certain mutual funds pursuant to which Merrill Lynch received payments from the funds in exchange for providing financial and other incentives to its sales force to sell the funds. Plaintiffs claimed that these distribution arrangements and Merrill Lynch's failure to disclose them constituted violations of Sections 12 and 15 of the Securities Act of 1933; Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934; Sections 34(b), 36(a), 36(b), and 48(a) of the Investment Company Act of 1940; Sections 206 and 215 of the Investment Advisers Act of 1940; and state law. With respect to the claim brought pursuant to Section 36(b), plaintiffs alleged that the investment adviser and distributor defendants charged "inflated" and "excessive" distribution and advisory fees. Defendants moved to dismiss the complaint in its entirely. Citing Gartenberg, the court agreed and dismissed plaintiffs' Section 36(b) claim, holding that plaintiffs' allegations were "conclusory" and devoid of any "factual support" and determined that plaintiffs failure to allege any facts about the negotiations of the fees at issue or the services provided in exchange for those fees required dismissal even under the liberal pleading standards of Rule 8. Id. at 240-41.

i. In Siemers v. Wells Fargo & Co., No. C 05-4518, 2006 WL 2355411 (N.D. Cal. Aug. 14, 2006), plaintiff asserted numerous claims relating to Wells Fargo's revenue sharing program. According to plaintiff, Wells Fargo and certain related defendants engaged in a purportedly undisclosed "scheme" to pay unaffiliated third party broker-dealers in an effort to induce their customers into purchasing Wells Fargo-branded mutual funds. Plaintiff

alleged that he was harmed by: (1) receiving biased advice from broker-dealers; and (2) the dissipation of fund assets by paying purportedly "excessive" fees to the investment advisers and distributor defendants. Plaintiff claimed that these "kickback" arrangements and Wells Fargo's failure to disclose them constituted violations of Sections 12 and 15 of the Securities Act of 1933; Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934; and Sections 36(b) and 48(a) of the Act. With respect to plaintiff's Section 36(b) claim, plaintiff alleged that: (1) as the funds' assets grew as a result of this purported "scheme," the benefits of such growth were improperly retained by defendants and were not shared with fund shareholders; (2) the expense ratios for the funds were higher than those for similarly situated funds in other complexes; (3) the funds' performance was poor and, therefore, the fees were not justified; (4) the investment adviser defendants improperly caused the funds to pay "higher-than-usual commissions" to financial consultants for services already being performed by the adviser and sub-adviser; (5) the funds' directors either failed to receive or declined to consider relevant information necessary for determining that any benefits resulting from increased fund assets were shared with the funds; and (6) defendants' "shelf-space" program conferred no benefit to the funds and its investors because defendants increased their fees in order to recoup the costs of direct payments to the broker-dealers. Id. at *16.

Defendants moved to dismiss plaintiff's Section 36(b) claim in its entirety, arguing that the plain language of Section 36(b) bars only the receipt of "excessive" fees but not the purportedly inappropriate use of fees. Moreover, defendants asserted that the plaintiff's allegations were too general in nature and not of the type mandated under Gartenberg and its progeny. The court disagreed. First, the court noted that neither the Supreme Court nor the Ninth Circuit have set forth standards for pleading a claim brought pursuant to Section 36(b), and that Gartenberg has limited precedential value outside of the Second Circuit. Moreover, the court noted that even if the standard enunciated by the Second Circuit was applicable, Gartenberg "did not purport to determine how to state a claim (i.e., set pleading standards), much less assert a heightened pleading standard." Id. at *18 (internal quotations omitted). After noting that the relevant factors courts should consider when determining the sufficiency of a claim brought pursuant to Section 36(b) are not limited to those detailed in Gartenberg, the court reviewed each factor in turn and determined that plaintiff's claim was, in fact, adequately plead. Despite this, the court found that the plaintiff failed to allege that he owned any of the relevant funds on the date the suit was commenced and

dismissed plaintiff's claim under Section 36(b) with leave to replead. Id. at *21.

In an attempt to cure the deficiencies identified in the court's August 14, 2006 ruling, the plaintiff filed an amended complaint based upon the same complained-of conduct relating to defendants' improper and undisclosed revenue sharing agreements with unaffiliated broker-dealers. See Siemers v. Wells Fargo & Co., No. C 05-4518, 2006 WL 3041090 (N.D. Cal. Oct. 24, 2006). Defendants again moved to dismiss plaintiff's Section 36(b) claim, arguing that the plaintiff lacked standing to sue on behalf of eighty-seven Wells Fargo-branded funds which he did not own, and the plaintiff's allegations concerning one of the distributor defendants, Stephens Inc., were insufficient to state a claim. According to defendants, the second amended complaint failed to allege that Stephens was: (1) an affiliate of any of the Wells Fargo-related defendants; (2) an "investment adviser" to the funds; or (3) an officer, director, advisory board member, or underwriter of any of the subject funds. After noting that the defendants were correct insofar as the complaint itself does not contain anything other than a reference to Stephens as a "distributor," the court noted that the funds' prospectuses specifically referred to Stephens as a "principal underwriter." According to the court, because the relevant prospectuses were incorporated into the complaint by reference, the plaintiff had, in fact, alleged and demonstrated that Stephens was a proper defendant under Section 36(b). See id. at *7-8.

Following several additional rounds of motion practice pertaining to various other alleged deficiencies in the operative complaint, the plaintiff filed a motion for class certification with respect to those claims alleging violations of Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934. See Siemers v. Wells Fargo & Co., 243 F.R.D. 369 (N.D. Cal. 2007). After an extensive analysis of the applicable standard for class certification pursuant to Rule 23, the court appointed lead plaintiff Siemers as the class representative and certified a class of "[a]ll purchasers of shares (of any class) bought between November 4, 2000, and June 8, 2005" for four mutual funds within the Wells Fargo family of funds. Id. at 371. With respect to plaintiff's claim asserting a violation of Section 36(b), the court bifurcated the proceeding and stayed plaintiff's Section 36(b) claim. Id. at 375. Importantly, the court found that, with respect to the remaining claims under the Exchange Act, the plaintiff would be required to demonstrate—to a jury—that the Adviser Defendant had a practice of extracting excessive advisory and other fees from the four funds, and that the excessiveness of such fees would be judged under the factors set

forth in Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982). See Siemers, 243 F.R.D. at 374. This unusual decision, therefore, appears to be the first time that a jury would be required to apply the Gartenberg factors to assess the excessiveness of fees received by an advisor and evidences a marked departure from the usual practice that a judge, and not a jury, is to determine whether the subject fees are, in fact, excessive under the standard set forth in Gartenberg. See Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 487 F. Supp. 999, 1001 (S.D.N.Y.) (holding that, because a determination of the excessiveness of the fees and the corresponding remedy is equitable in nature, plaintiffs are not entitled to a jury trial), aff'd sub nom. In re Gartenberg, 636 F.2d 16 (2d Cir. 1980), cert. denied sub nom. Gartenberg v. Pollack, 451 U.S. 910 (1981). On July 5, 2007, the parties entered into a stipulation of settlement.

j. On August 29, 2006, Edward D. Jones ("Edward Jones"), various Edward Jones affiliates, and a number of individual defendants agreed to settle several class actions alleging that Defendants shoehorned as many investors as possible into a limited number of "preferred" mutual fund families in exchange for hundreds of millions of dollars in cash payments from those preferred funds but concealed the arrangement and the conflicts of interest it created from its clients. (The preferred funds included mutual funds in seven fund complexes: Lord Abbett Funds; American Funds; Federated Funds; Goldman Sachs Funds; Hartford Funds; Putnam Funds; and Van Kampen Funds.) The settlement also covered two actions originally filed in state courts that alleged the Defendants' receipt and retention of the cash payments while holding its clients' assets in trust constituted a breach of fiduciary duty. See Spahn v. Edward D. Jones & Co., No. 04 CV 00086 (E. D. Mo.) (Memorandum of Law in Support of Lead Plaintiffs' Amended Motion for An Order Preliminarily Approving Class Action Settlement, Conditionally Certifying the Settlement Class, Approving the Form and Manner of Notice, and Setting Fairness Hearing (D.I. 187)). Defendants agreed to pay $127.5 million consisting of a $55 million cash component and a $72.5 million non-cash component. See id.

k. In Gilliam v. Fidelity Management & Research Co., No 04-11600, slip op. (D. Mass. Sept. 18, 2006), plaintiffs alleged that defendants made undisclosed, improper, and excessive payments to unaffiliated broker-dealers to promote the sale of Fidelity-branded mutual funds over other funds. Plaintiffs alleged that this purported "scheme" resulted in a marked increase in fund assets, the benefits of which were wrongfully retained by the defendants and were not shared with fund investors. Based on these

allegations, plaintiffs brought claims under Sections 34(b), 36(a), 36(b), and 48(a) of the Act; Sections 206 and 215 of the Investment Advisers Act of 1940; and common law claims for breach of fiduciary duty and unjust enrichment. Defendants moved to dismiss the complaint in its entirety, including plaintiffs' claim under Section 36(b) arguing, inter alia, that the claim was improperly brought directly as a putative class action rather than derivatively on behalf of the subject funds. After an extensive analysis of the plain language, legislative history, and various decisions interpreting the scope of a cause of action brought pursuant to Section 36(b), the court concluded that Congress intended only to create a derivative, and not direct, cause of action and recommended dismissal of plaintiffs' claim. In so doing, the court acknowledged that previous decisions in the District of Massachusetts had characterized Section 36(b) claims as direct, but declined to follow such precedent based on a determination that such decisions were the result of "imprecise" findings. Moreover, the court analyzed the substantive law of the funds' states of incorporation—in this case, Massachusetts and Delaware—and found additional support for its determination that the Section 36(b) claim asserted by plaintiffs is, in fact, derivative. See id. at 23-47. The action was subsequently voluntarily dismissed with prejudice.

l. In Boyce v. AIM Management Group, Inc., No. H-04-2587, 2006 WL 4671324 (S.D. Tex. Sept. 29, 2006), plaintiffs alleged that the advisers, distributors, and directors of the AIM-branded family of funds violated Sections 34(b), 36(a), 36(b), and 48(a) of the Act; Section 215 of the Investment Advisers Act of 1940, and state law by making excessive revenue sharing payments to unaffiliated broker-dealers, which ultimately resulted in an increase in asset-based fees paid to defendants. Id. at *1. Judge Ellison dismissed the Section 36(b) claim, with leave to replead, for failure to assert that cause of action derivatively, rather than directly. Id. at *3. The court found that the source of the confusion over whether Section 36(b) provides for a direct rather than derivative right of action stems from "a statement that Supreme Court made in Kamen v. Kemper Financial Services, Inc., 500 U.S. 90 (1991)." Boyce, 2006 WL 4671324, at *3. The court noted, however, that the "more sensible interpretation is that the Court's reference to Section 36(b) as 'direct' was not intended to reverse the [Supreme Court's earlier] holding of Daily Income, but merely to emphasize that a shareholder can bring a derivative claim under Section 36(b) 'directly,' i.e., without first making a demand on the corporation. Id. (citing In re Am. Mutual Funds Fee Litig., 2005 WL 3989803, at *3 (C.D. Cal. Dec. 16, 2005)). The court thus dismissed the Section 36(b) claim with leave to replead.

Following the court's ruling on defendants' motion to dismiss, plaintiffs filed a third amended complaint, asserting their ICA Section 36(b) claim derivatively on behalf of the subject funds. See Boyce v. AIM Mgmt. Group, Inc., No. H-04-2587, 2007 WL 7117575 (S.D. Tex. Sept. 17, 2007). Defendants moved to dismiss the complaint or, alternatively, for reconsideration of the court's September 29, 2006 decision granting plaintiffs the opportunity to replead their Section 36(b) claim derivatively. Defendants argued, consistent with Judge Martini's decision in In re Lord Abbett Mutual Funds Fee Litigation, No. 04-CV-559, 2006 WL 3483946 (D.N.J. Dec. 4, 2006), that the court's previous decision dismissing state law claims as preempted under SLUSA required dismissal of the entire action, including plaintiffs' Section 36(b) claim. Defendants also argued that the previous complaint was insufficient to constitute an "action" for purposes of Section 36(b)'s one year look-back damages period because it was improperly asserted directly as a putative class action rather than derivatively on behalf of the subject funds. According to defendants, the "action," as defined by Section 36(b), was instituted once plaintiffs asserted their claim derivatively and that plaintiffs failed to allege any facts within the applicable one-year period. See Boyce, 2007 WL 7117575, at *3-6. Citing Judge Feess' decision in In re American Mutual Funds Fee Litigation, No CV 04-5593, slip op. (C.D. Cal. Jan. 17, 2007), plaintiffs argued that SLUSA did not mandate dismissal of the entire action, and that the "action" for purposes of Section 36(b)'s one-year look back provision was triggered upon the filing of the initial complaint. See Boyce, 2007 WL 7117575, at *3.

Judge Ellison rejected defendants' argument that the court's prior dismissal of plaintiffs' state law claims as preempted under SLUSA required the dismissal of the entire action, finding that "if Congress intended SLUSA to preclude both federal and state claims presented in a 'covered class action,' such indication would be apparent. It is not." Id. at *5. The court, however, agreed with defendants' interpretation of the word "action" as it relates to Section 36(b)'s one-year look back period, finding that "[n]o 'action' meeting the section 36(b) statutory provision was filed until December 7, 2006, when plaintiff filed an 'action' 'on behalf of such company.' Until that time, only a class action lawsuit—a claim not cognizable under section 36(b)—was on file." Id. at *6. Moreover, the court found that the "relation back" of amendments provision was inapplicable to cases brought pursuant to Section 36(b), holding that a rule of procedure may not be used to modify a substantive damages limitation. Id. Finally, the court held that because plaintiffs failed to plead facts alleging damages within the relevant "look-back" period, the cause of action brought pursuant

to Section 36(b) failed to state a claim, and dismissed plaintiffs' complaint with prejudice. Id. at *6-7.

m. In In re Scudder Mutual Funds Fee Litigation, No. 04 Civ. 1921, 2007 WL 2325862 (S.D.N.Y. Aug. 14, 2007), another revenue sharing action, plaintiffs alleged that Deutsche Bank and certain affiliated entities engaged in a scheme to improperly induce unaffiliated broker-dealers to steer investors towards Scudder-branded mutual funds, the result of which increased fund assets and corresponding fees. Plaintiffs further allege that several of the Trustees were current or former employees of the Investment Advisor Defendants, creating a conflict of interest between "the interest in siphoning fees from shareholders to induce brokers to sell the Funds' shares" and the interests of the fund shareholders. Id. at *2-3. According to plaintiffs, this purported "conflict" was manifested in several improper practices, including, inter alia, inappropriate revenue-sharing arrangements, so-called "soft-dollar kickbacks," and the failure to pass on the benefits of scale economies to fund shareholders. Id. at *3. Plaintiffs allege that these activities constituted violations of Sections 36(b) and 48(a) of the Act. Defendants moved to dismiss the complaint in its entirety, including plaintiffs' Section 36(b) claim, arguing that: (1) plaintiffs improperly asserted their claim directly as a putative class action rather than derivatively on behalf of the subject funds; and (2) plaintiffs' Section 36(b) allegations were insufficient to state a claim.

Judge Batts agreed and dismissed plaintiffs' Section 36(b) cause of action in its entirety with prejudice. The court first addressed defendants' argument that a Section 36(b) claim may only be brought derivatively on behalf of the funds rather than directly by fund shareholders. After analyzing the plain language of Section 36(b) and relevant case law directly on point, the court held that the text of the statute coupled with dicta from the Supreme Court's decision in Daily Income and the Second Circuit's language in Olmsted v. Pruco Life Ins. Co. of New Jersey, 283 F.3d 429 (2d Cir. 2002), "requires a ruling that Section 36(b) provides for derivative, not direct, suits." In re Scudder, 2007 WL 2325862, at *13. Moreover, the court also found that the allegations in the complaint were insufficient to state a claim under Section 36(b). Citing Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923 (2d Cir. 1982), the court analyzed each of the six relevant factors in turn, and concluded that plaintiffs' complaint failed to state a claim. Specifically, the court found that plaintiffs' bald allegations that: (1) the nature and quality of services deteriorated because several high-level employees departed from the Scudder complex; (2) the purported soft-dollar kickbacks were an improper

use of fund assets; (3) the benefits of economies of scale were improperly retained by defendants and not passed on to fund investors; and (4) the funds' Trustees lacked independence and conscientiousness merely because two of the Trustees were allegedly employees of the defendants, lacked the requisite specificity to state a claim under Section 36(b). In re Scudder, 2007 WL 2325862, at *13-18.

n. In Alexander v. Allianz Dresdner Asset Management of America Holding, Inc., 509 F. Supp. 2d 190 (D. Conn. 2007), plaintiffs alleged that defendants used assets from the PIMCO-branded family of mutual funds to make improper "shelf-space" payments to unaffiliated broker-dealers in exchange for promoting the funds to unwitting investors. Id. at 193. Plaintiffs alleged that these payments violated: (1) Sections 34(b), 36(a), 36(b) and 48(a) of the ICA; (2) Section 215 of the Investment Advisers Act of 1940; and (3) various claims under state common law, including breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and unjust enrichment. Id. at 193-94. Defendants moved to dismiss the complaint in its entirety, including plaintiffs' Section 36(b) claim. According to the defendants, plaintiffs' allegations that defendants breached their fiduciary duty by "improperly charging investors in the Funds purported Rule 12b-1 marketing fees" and by "improperly inflating management fees by shifting expenses from the Investment Advisers to the Funds' investors without a corresponding reduction in the management fees" was insufficient to state a viable claim under Section 36(b). The court agreed. Citing the Second Circuit's decisions in Gartenberg and Eaton Vance, the court found that plaintiffs' allegations that the defendants used fees for an improper purpose was insufficient to state a cause of action pursuant to Section 36(b). See Allianz Dresdner Asset Mgmt., 509 F. Supp. 2d at 195-96.

o. In Hoffman v. UBS-AG, 591 F. Supp. 2d 522 (S.D.N.Y. 2008), investors in various UBS mutual funds brought a putative class action involving revenue sharing against, inter alia, the investment adviser and distributor of the UBS proprietary funds. Plaintiffs alleged violations of various provisions of the Act, the Securities Act, and the Securities Exchange Act. With respect to the Act, plaintiffs asserted claims under Section 36(b) both directly and derivatively. Defendants moved to dismiss both. The court as an initial matter adopted Judge Batts' analysis in In re Scudder to conclude that Section 36(b) provides for derivative, not direct, suits, and granted defendants' motion as to the direct claim. See Hoffman, 591 F. Supp. 2d at 538. Turning to the derivative claims, Judge Sand held that plaintiffs had not pled facts relating to the Gartenberg factors as required under Second Circuit

jurisprudence. Judge Sand held that allegations of underperformance alone are not sufficient; the complaint did not allege sufficient information for the court to determine the profitability of defendants, "which is a prerequisite to establishing [the profitability] factor"; plaintiffs' allegations concerning fall-out benefits referred to the propriety of the fees, not the amount charged; plaintiffs' allegations did not satisfy the economies of scale factor; plaintiffs did not make appropriate comparisons to other mutual funds; and plaintiffs' reference to statements of SEC officials about mutual fund directors generally and to a Forbes magazine article about the UBS board of directors were insufficient to challenge the presumption of disinterestedness under the Act. Id. at 538-41.

Rule 12b-1 Plans / Funds Closed to New Investors

a. In Korland v. Capital Research and Management Company, No. CV-08-4020, 2006 WL 936612 (C.D. Cal. Feb. 10, 2009), plaintiff, a shareholder in the $100 billion EuroPacific Growth Fund (the "Fund" or "EUPAC") challenged the Fund's payment of post-sale Rule 12b-1 fees to broker-dealers for servicing Fund shareholders. Plaintiff claimed that the Rule 12b-1 fees paid by EUPAC were improper and therefore *per se* excessive in violation of Sections 36(b) and 48(a) of the Act. Rule 12b-1, enacted by the SEC in 1980, provides a mechanism by which a mutual fund may use its assets to pay for activities primarily intended to result in the sale of fund shares. In response to this Rule, EUPAC, like many mutual funds, enacted a "Rule 12b-1 plan" which allowed the fund to use fund fees to pay for distribution, as well as for activities relating to post-sale shareholder services. Plaintiff alleged that this latter use—payments to broker-dealers for ongoing service advice rendered by individual financial consultants—was an activity which did not "result in the sale of fund shares" and was therefore *per se* illegal.

Defendants moved to dismiss the complaint, arguing that there is no such thing as a *per se* violation of Section 36(b) and that the plaintiff failed to state a claim under the six-factor Gartenberg test which governs mutual fund excessive fee actions. Defendants highlighted for the court the 28-year history of Rule 12b-1, and the fact that the SEC had recognized that post-sale shareholder services encourages mutual fund shareholders to purchase new or additional fund shares.

The court (Feess, D.J.) held that under applicable case law, it was insufficient under Section 36(b) for plaintiff to plead that an expenditure under Rule 12b-1 was "*per se*" unlawful or

unauthorized; "more must be alleged." Judge Feess went on to state that the mere allegation "that fees are used for an improper purpose" is also not sufficient to state a Section 36(b) claim. Judge Feess explained that if plaintiff chooses to replead, plaintiff must plead detailed Gartenberg-style allegations. Lastly, Judge Feess held that there is no private right of action for controlling person liability under Section 48(a) of the ICA, and dismissed that claim with prejudice.

b. In Mintz v. Baron, No. 05 Civ. 4904, 2006 WL 2707338 (S.D.N.Y. Sept. 19, 2006), plaintiffs, shareholders in two Baron-branded mutual funds, brought claims under Section 36(b) of the Act, as well as a state law claim for breach of fiduciary duty, against the funds' investment adviser, distributor, and a select group of trustees of the Baron funds. Plaintiffs' claims related to certain distribution payments made pursuant to Rule 12b-1 that were charged to funds that were closed to new investors. According to plaintiffs, once the funds at issue closed to new investors, the distribution and service fees far exceeded the minimal costs actually incurred, and defendants' receipt of those fees constituted a breach of their fiduciary duties under Section 36(b). See id. at *2. Defendants moved to dismiss. With respect to the claim under Section 36(b), defendants argued that the allegations pertaining to the complained-of conduct (i.e., the receipt of Rule 12b-1 fees despite the fact that the funds at issue were closed) failed to state a claim "because the Funds' prospectus demonstrates that they are open to additional investments by certain categories of investors and that the relevant 12b-1 plan permits payment of administrative, as well as marketing expenses." Id. at *4. Citing Gartenberg, the court analyzed each of the relevant factors in turn and concluded that plaintiffs' allegations were "barely" sufficient to survive a motion to dismiss. Id. at *4.

The court, however, made two additional rulings with respect to Section 36(b). First, the court dismissed the Section 36(b) claim as to the investment adviser defendant because Section 36(b) only applies to recipients of the fees in question, which plaintiffs did not allege. See id. at *3. Second, the court noted that plaintiffs improperly asserted their Section 36(b) claim directly on behalf of a putative class of shareholders rather than derivatively on behalf of the subject funds. Accordingly, the court directed plaintiffs to either replead their Section 36(b) claim derivatively or, alternatively, to "show cause in writing as to why such amendment is not necessary." Id. at *4.

Following the court's ruling on defendants' motion to dismiss, plaintiffs filed a second amended complaint, asserting substantially

similar allegations. Again, defendants moved to dismiss, arguing that the complaint failed to adequately allege a violation of Section 36(b), as set forth by the Second Circuit in Gartenberg and reiterated in Amron. The court agreed, noting that the Supreme Court's decision in Twombly v. Bell Atlantic, 550 U.S. 544 (2007), required a detailed application and examination of each of the Gartenberg factors. After reviewing each factor in turn, the court found the amended complaint inadequate, holding that "[i]n the absence of facts sufficient to provide context for any Gartenberg factor that would support Plaintiffs' claim of excessive fees, the Amended Complaint fails to state plausibly a claim under Section 36(b)." See Mintz v. Baron, No. 05 Civ. 4904, 2009 WL 735140, at *4 (S.D.N.Y. Mar. 20, 2009).

c. See also Zucker v. Federated Shareholder Svcs. Co., No. 2:06cv241, 2007 WL 709305 (W.D. Pa. Mar. 5, 2007) (dismissing plaintiffs' Section 36(b) claim pertaining to the improper receipt of redemption, transfer agency, and other fees charged to shareholders in a closed fund within the Federated mutual fund complex for: (1) failure to assert the claim derivatively on behalf of the subject fund; and (2) failing to allege that several defendants were recipients of the subject fees).

d. In Curran v. Principal Management Corp., No. 4:09-cv-433, 2010 WL 2889752 (S.D. Iowa June 8, 2010), investors in two "funds of funds" (i.e., mutual funds that invest in other mutual funds), alleged that defendants violated Section 36(b) in charging excessive advisory fees, receiving excessive profits due to economies of scale, and with regard to excessive Rule 12b-1 fees (counts I, II and III, respectively). Notably, plaintiffs brought these claims on behalf of the funds in which they owned shares (i.e., the funds of funds), and the underlying funds which those funds invested in. The "funds of funds" and the underlying funds were all part of the Principal fund complex.

With regard to plaintiffs' Rule 12b-1 claim, the court stated that plaintiffs "have met their burden by alleging that fees collected by [the distributor] for its distribution services surpassed the value of those services, and that the manner in which those fees were assessed did not correspond to the type of services performed but, rather, resemble fees collected for advisory services." Id. at *11. Thus, noting that defendants' arguments were largely factual in nature, the court concluded that "the allegations set forth in Count III are sufficient to raise an inference that the distribution fees collected by [the distributor] were additional and excessive compensation for advisory services subject to a § 36(b) claim." Id.

On May 17, 2013, the parties alerted the court that the surviving portion of the action had settled. The court approved the parties' settlement on June 12, 2013, and dismissed the action with prejudice.

e. In a different approach to asserting liability in connection with the payment of Rule 12b-1 fees, the plaintiff in Smith v. Franklin/Templeton Distributors, Inc., No. C-09-4775, 2010 WL 3248644 (N.D. Cal. June 8, 2010), alleged that Franklin/Templeton Fund Distributors ("FTD"), the principal underwriter and distributor of Franklin Custodian Funds (the "Trust"), and certain members of the board of trustees of the Trust, violated Section 47(b) of the Act by paying Rule 12b-1 fees to broker-dealers. Section 47(b) makes unenforceable by either party a contract "that is made, or whose performance involves, a violation of [the Act], or of any rule, regulation, or order thereunder." 15 U.S.C. § 80a-46(b)(1). Plaintiff contended that the Rule 12b-1 fees paid were asset-based compensation prohibited by Section 202 of the IAA and, thus, the distribution plans pursuant to which the fees were paid were unenforceable under Section 47(b).

Defendants moved to dismiss the complaint, arguing that Section 47(b) is strictly a remedy section; a plaintiff must allege a viable predicate violation in connection with Section 47(b). The court agreed with defendants, holding that "a plaintiff can seek relief under § 47(b) only by asserting a violation of some other section of the ICA." Franklin/Templeton, 2010 WL 2348644, at *7 (citing cases). "The court finds no language in ICA § 47(b) sufficient to create a private right of action under that statute, absent a showing of some other violation of the ICA." Id. Nor, held the court, can a violation of the IAA be the predicate for the Section 47(b) claim, as "[Section] 47(b) applies only to a contract that is made, or whose performance involves, a violation of the ICA." Id. at *8 (quotations omitted). The court dismissed the action with leave to replead. Id.

Plaintiff subsequently filed an amended complaint in which he asserted a claim for "contract voiding" pursuant to Section 47(b). In his complaint, Plaintiff asserted that the Trust "seeks a declaration that the contractual obligation to make payments of Trust assets in the form of asset-based compensation to broker-dealers holding Trust shares in brokerage account [sic] violates the Trustees' duties under Section 36(a) of the ICA and Rule 38a-1 to avoid improper use of Trust assets," and alleged that "due to the violation of core provisions of the ICA, Section 36(a) and Rule 38a-1 . . . that require proper and lawful use of Trust assets, the Trust seeks to have its own contractual obligations deemed to be

void by reason of Section 47(b), in an action maintained under Section 47(b)." Smith v. Franklin/Templeton Distribs., Inc., No. C 09-4775, 2010 WL 4286326, at *1 (N.D. Cal. Oct. 22, 2010).

Defendants again moved to dismiss for failure to state a claim, which the court granted before a scheduled hearing on the motion. The court held that plaintiff's amended complaint failed to allege facts sufficient to show a predicate violation of either Section 36(a) or Rule 38a-1. Id. at *2. The court held that neither Section 36(a) nor Rule 38a-1 provide an express or implied private right of action. Nor does Section 36(a) create a federal fiduciary duty or regulate the improper use of Trust assets, or provide a right of action for a claim for breach thereof. Id. Similarly, the court held that "Rule 38a-1 does not impose on funds a duty to assure that broker-dealers comply with registration requirements, but rather simply requires funds to adopt and implement compliance programs that are reasonably designed to prevent violation of the federal securities laws." Id. at *3. As such, plaintiff did not plead facts sufficient to show any violation of Rule 38a-1.

The court dismissed the federal claim in the amended complaint without leave to amend. The court declined to exercise supplemental jurisdiction over the state law claims and dismissed those claims without prejudice to refiling in state court. Id.

2. Market Timing and Late Trading

On August 25, 2005, Judge Motz in the District of Maryland issued the first of the decisions on motions to dismiss in the numerous tracks and sub-tracks in the market timing and late trading multi-district litigation. See In re Mutual Funds Inv. Litig. (In re Janus Subtrack Investor Class Op.), 384 F. Supp. 2d 845 (D. Md. 2005) ("Market Timing Class Op."); In re Mutual Funds Inv. Litig. (In re Janus Subtrack Fund Derivative Op.), 384 F. Supp. 2d 873 (D. Md. 2005) ("Market Timing Derivative Op."). With respect to the investor class actions, the court held that plaintiffs' allegations that: (1) management fees, which were based on the amount of funds under management, were increased excessively by late trades and market timed transactions that increased the funds under management; (2) the influx of funds from late trades and market-timed transactions excessively increased fees paid by funds for distribution of shares; and (3) the management fees paid as a result of the deposit of so-called "sticky assets" that would "sit quietly, in low-risk money-market or government bond funds" were entirely unearned, stated a claim under Section 36(b). Market Timing Class Op., 384 F. Supp. 2d at 867-68.

On May 30, 2006, Judge Motz issued a series of letter opinions in the market timing and late trading multi-district litigation discussing the scope of liability under Section 36(b). See In re Mutual Funds Inv. Litig. (In re Van Kampen

Funds Sub-Track), No. MDL-15863, 2006 WL 1581176 (D. Md. May 30, 2006); In re Mutual Funds Inv. Litig. (In re AIM/Invesco Sub-Track), No. MDL-15864, 2006 WL 1581193 (D. Md. May 30, 2006). With respect to the Van Kampen sub-track, defendants' sought reconsideration of the court's March 1, 2006 order permitting plaintiff to pursue its claims under Sections 36(b) and 48(a), arguing that plaintiff had failed to allege facts sufficient to sustain a claim within the one year look-back period applicable to claims brought under Section 36(b). The court agreed, finding that the complaint did not include any allegations within the applicable time period and dismissed plaintiff's claims under the Act accordingly. See In re Van Kampen, 2006 WL 1581176, at *1-2.

On the same day as Van Kampen, Judge Motz dismissed plaintiffs' claims brought under Sections 36(b) and 48(a) in the AIM/Invesco sub-track, finding that plaintiffs failed to allege that defendants "actually received the purportedly excessive compensation" at issue and held that defendants could not, therefore, be subject to secondary liability under Section 48(a). AIM/Invesco Sub-Track, 2006 WL 1581193, at *1.

Recently, Judge Motz issued several additional letter opinions dismissing plaintiffs' Section 36(b) claims against the trustees of several funds. According to the court, plaintiffs failed to allege that that the trustees were recipients of the subject fees, as required by Section 36(b), rendering the allegations "insufficient to support a viable 36(b) claim." In re Mutual Funds Inv. Litig. (In re RS Investment Sub-Track), No. 04-md-15863, slip op. at *2 (D. Md. July 7, 2006); In re Mutual Funds Inv. Litig. (In re Alger Sub-Track), No. 04-md-15863, slip op. at *2 (D. Md. July 7, 2006).

On December 28, 2006, Judge Motz issued an Order entering final judgment dismissing claims in the Market Timing MDL against William Wolverton, former general counsel of Putnam. Plaintiffs had alleged that Wolverton violated Section 36(b) of the Act in that as general counsel of Putnam he failed to stop market timing activities and was a recipient of asset managements fees by virtue of receiving his salary. Plaintiffs also alleged that Wolverton violated Section 48 of the Act as a control person in that he caused to be done through others what would be unlawful under the Act for he himself to do. Judge Motz agreed with Wolverton that his salary did not constitute the receipt of fees contemplated by Congress in connection with Section 36(b) and, thus, there was no Section 36(b) violation. Further, without an underlying violation of Section 36(b), there could be no violation of Section 48. See Zuber v. Putnam Inv. Mgmt. LLC, et al., No. 04-cv-564, slip op. (D. Md. Dec. 28, 2006) (D.I. 2298-2).

On December 30, 2008, Judge Motz issued a decision in the Janus and Putnam sub-tracks denying defendants' motion for summary judgment on the Section 36(b) claims. See In re Mutual Funds Inv. Litig., 590 F. Supp. 2d 741 (D. Md. 2008). Judge Motz echoed his earlier ruling denying motions to dismiss the Section 36(b) claims asserted against the Janus defendants and held, without substantial analysis, that "[t]o the extent that a portion of the fees paid to the

investment adviser defendants was 'disproportionate, excessive, or unearned,' . . . because it was based upon the existence of market timing agreements or of insider market-timed trades not disclosed when the fees were negotiated, plaintiffs (derivatively, on behalf of the funds that paid the fees) may recover that portion of the fees." Id. at 759-60. It is worth noting that Judge Motz acknowledged the two different approaches to deciding the viability of Section 36(b) claims that have evolved—Gartenberg and Jones v. Harris—but found that the two approaches lead to the same place. Id.

On January 20, 2010, Judge Motz issued a decision in the Janus funds derivative litigation granting defendants' motion for summary judgment on plaintiffs' claim under Section 36(b)—the sole remaining claim in that action. See In re Mutual Funds Inv. Litig., 681 F. Supp. 2d 622 (D. Md. 2010). In doing so, Judge Motz held that the fiduciary duty under Section 36(b) has a scienter component. Id. at 628. According to the court:

> [A]llowing recovery in the absence of intentional or reckless adviser misconduct would be to concentrate on the compensation itself, not on the adviser's actions. This focusing on the compensation itself, and ignoring the advisers' conduct, would allow Section 36(b) to be used to *de facto* challenge the reasonableness of the fees, which is inconsistent with the text and intent of 36(b).

Id. As such, the court ruled, whether viewed under the "excessive/disproportionate" test of Gartenberg and its progeny, or the "honest negotiation" test of Jones v. Harris—the court held that it need not resolve which of the two standards is most appropriate because they both lead to the same place—Defendants could only be liable for the "'portion of the fees paid to the [Janus Defendants that] was disproportionate, excessive, or unearned . . . because it was based on the existence of market timing agreements or of insider market-timed trades not disclosed when the fees were negotiated . . . .'" Id. (quoting In re Mutual Funds Inv. Litig., 590 F. Supp. 2d 741, 760 (D. Md. 2008)).

Importantly, no other court has held that the fiduciary duty under Section 36(b) has a scienter requirement, a fact Judge Motz squarely acknowledges: "I suspect this is because proof of breach is usually powerful evidence of the adviser's state of mind." In re Mutual Funds Inv. Litig., 681 F. Supp. 2d at 629 n.12.

3. Outsourcing Payments to Affiliated Entities

a. In In re Smith Barney Transfer Agent Litig., No. 05 Civ. 7583, 2007 WL 2809600 (S.D.N.Y. Sept. 26, 2007), plaintiffs alleged that in 1999 defendants recommended that the funds retain the services of what is now known as Citicorp Trust Bank ("CTB"), an affiliate of the funds' investment adviser, to serve as the primary transfer agent for the funds. Although CTB was responsible for providing all of the Smith Barney-branded mutual funds' transfer

agent services, CTB allegedly subcontracted the vast majority of the transfer agent work to First Data Investor Services Group ("First Data"). Pursuant to this subcontract, it was alleged that First Data charged significantly lower fees, yet CTB did not pass on those discounts to the funds, nor did the funds' investment adviser disclose to the funds such discounts or that First Data performed most of the transfer agent services. Id. at *1. Based on these allegations, plaintiffs asserted claims under Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934 and Section 36(b) of the Act. Defendants moved to dismiss the complaint in its entirety, including plaintiffs' Section 36(b) claim, arguing, inter alia, that the claim was improperly asserted directly as a putative class action rather than derivatively on behalf of the subject funds. Id. at *4. The court agreed and dismissed plaintiffs' Section 36(b) claim. Id. Applying the law of the state of the funds' incorporation, the court held that the purported injury was suffered, if at all, directly by the funds, and that the claims were therefore derivative in nature. Id.

One of the plaintiffs appealed the decision. On appeal, the United States Court of Appeals agreed with the district court that an action under Section 36(b) is derivative, and rejected plaintiff's argument that it could assert claims under Section 36(b) in which the recovery would go to it directly. Operating Local 649 Annuity Trust Fund v. Smith Barney Fund Mgmt. LLC, 595 F.3d 86, 97 (2d Cir. 2010). "To the extent Local 649 seeks damages that inure to its own benefit and not to the Funds', that result is not permitted by § 36(b)." Id. at 98. The Second Circuit reversed the district court's dismissal of plaintiffs' securities fraud claim and remanded.

On remand, the defendants filed another motion to dismiss, which the district court granted in part and denied in part. See In re Smith Barney Transfer Agent Litig., 765 F. Supp. 2d 391 (S.D.N.Y. 2010). The court first discussed defendants' argument that plaintiffs lacked standing. With regard to the argument that plaintiffs should have brought their Section 10(b) claim derivatively—because plaintiffs only alleged harm to the funds—the court rejected defendants' argument: because plaintiffs claimed they were "fraudulently induced to purchase shares . . . they can be said to have suffered a direct injury." See In re Smith Barney, 765 F. Supp. 2d at 399.

Next, the court held that plaintiffs lacked standing to pursue claims on behalf of funds in which no named plaintiff invested, and dismissed claims "on behalf of mere holders of Smith Barney

Funds securities," because "§ 10(b) limited private causes to action to purchasers and sellers." Id. at 399-400.

The court then rejected defendants' argument that plaintiffs' claims were time-barred. With regard to news articles cited by defendants, the court noted that the articles' reference to investigators "trying to determine Defendants' culpability demonstrates that any evidence of Defendants' mental state had not yet been uncovered. Thus, because a reasonably diligent investor would not necessarily have discovered facts establishing that Defendants acted intentionally or with reckless disregard, Plaintiffs' claims are not time-barred." Id. at 400-01 (citations omitted).

Next, the court dismissed one of the individual defendants on the grounds that he did not make any of the false statements alleged in the complaint. While the court acknowledged the efficacy of the group pleading doctrine, which presumes that corporate disclosures are the collective work of, and can be attributed to, those with "direct involvement in the everyday business of the company," the court declined to apply the doctrine to the chief executive officer of Citigroup Asset Management. Id. at 401. The court found that since the complaint alleged no direct involvement by the individual in the adviser's recommendations to the funds' board, and because the individual was not an officer of the Smith Barney funds, that it would be inappropriate to apply the doctrine against him. Id.; see also id. at 402 (dismissing Section 20(a) claim against this individual).

Shockingly, lead plaintiffs' counsel subsequently informed the court that the lead plaintiff did not actually own shares in the at-issue fund (rather lead plaintiff owned shares in a similarly named fund). After excoriating the lawyers for both sides for letting this error go unnoticed for six years of litigation, the court dismissed lead plaintiff and set a briefing schedule for an appointment of a new lead plaintiff and lead counsel. See In re Smith Barney Transfer Agent Litig., No. 05 Civ. 7583, 2011 WL 4430857 (S.D.N.Y. Sept. 22, 2011).

After plaintiffs resolved the standing issue, plaintiffs re-filed their action, and defendants again moved to dismiss. The court ultimately dismissed the claims against the investment adviser and one of the individual defendants for failure to plead reliance, but sustained a Rule 10b-5(b) claim against another individual defendant who had signed allegedly misleading fund documents. See infra In re Smith Barney Fund Transfer Agent Litig., No. 05 Civ. 7583, 2012 WL 3339098 (S.D.N.Y. Aug. 15, 2012).

4. Securities Lending

a. In Laborers' Local 265 Pension Fund v. iShares Trust, No. 3:13-cv-00046, 2013 WL 4604183 (M.D. Tenn. Aug. 28, 2013), plaintiffs, investors in certain iShares exchange traded funds, filed a derivative action on behalf of the funds, asserting claims under Sections 36(a), 36(b) and 47(b) of the Act and seeking the return of allegedly "excessive" fees, contractual rescission and injunctive relief. Plaintiffs asserted the claims against the funds as nominal defendants, as well as BlackRock Fund Advisors ("BFA"), BlackRock Institutional Trust Company, N.A. ("BTC") and individual directors of the funds. BFA acted as investment adviser to the funds, while BTC was hired by BFA to act as securities lending agent to the funds. Plaintiffs sought to recover revenue derived from BTC's lending of the funds' securities, alleging that the 35 percent fee-split of this revenue, approved by the funds' directors, was excessive. Id. at *1-2.

Plaintiffs also alleged that an additional 5 percent of securities lending revenue was paid to BlackRock affiliates as administrative fees, resulting in a "40/60 division of revenue between the BlackRock affiliates and the iShares funds" that was likewise excessive, when compared to fees paid by "peer mutual funds, and, in particular, compared to funds which employ unaffiliated lending agents." Id. at *2.

In dismissing plaintiffs' Section 36(b) claim, the court relied primarily on an SEC Exemption Order issued pursuant to Sections 6(c) and 17(b) of the Act, which applied to the securities lending agreement at issue. The court explained that because Section 36(b)(4) of the Act provides that Section 36(b) is inapplicable to payments or compensation made in connection with orders under Section 17 of the Act, plaintiffs' Section 36(b) claim must be dismissed. Id. at *3, *5-6.

The court also dismissed plaintiffs' claims under Sections 36(a) and 47(b), finding that plaintiffs failed to overcome the presumption that no private right of action exists under those sections of the Act. Id. at *6-10.

Although the court's dismissal was without prejudice and provided plaintiffs with an opportunity to file a motion for leave to amend by September 17, 2013, the court specifically noted that if such a motion was not filed, "the court will enter final judgment in the case." Id. at *10. Plaintiffs subsequently sought an extension of time to file their motion by October 17, 2013, which was granted. After the extended deadline passed, on October 22, 2013,

defendants moved to dismiss the case, which the court granted shortly thereafter. See Laborers' Local 265 Pension Fund v. iShares Trust, No. 3:13-cv-00046 (M.D. Tenn. Oct. 24, 2013).

5. Other Attempts to Expand the Scope of Section 36(b)

Over the years, plaintiffs have tried in earnest to expand the scope of Section 36(b), by challenging:

a. Failure to participate in class actions—see Hamilton v. Allen, 396 F. Supp. 2d 545 (E.D. Pa. 2005); Stegall v. Ladner, 394 F. Supp. 2d 358 (D. Mass. 2005); Hogan v. Baker, No. Civ. A. 305CV73P, 2005 WL 1949476 (N.D. Tex. Aug. 12, 2005); Dull v. Arch, No. 05 C 140, 2005 WL 1799270 (N.D. Ill. July 27, 2005); Jacobs v. Bremner, 378 F. Supp. 2d 861 (N.D. Ill. 2005); Mutchka v. Harris, 373 F. Supp. 2d 1021 (C.D. Cal. 2005); Davis v. Bailey, No. CIVA05CV42, 2005 WL 3527286 (D. Colo. Dec. 22, 2005); Everett v. Bozic, No. Civ. 00296, 2006 WL 2291083 (S.D.N.Y. Aug. 3, 2006).

b. Portfolio selections—see Benak v. Alliance Capital Mgmt. L.P., No. Civ. A. 01-5734, 2004 WL 1459249 (D.N.J. Feb. 9, 2004).

c. Fund mergers—see Olesh v. Dreyfus Corp., No. CV-94-1664, 1995 WL 500491 (E.D.N.Y. Aug. 8, 1995); Wexler v. Equitable Capital Mgmt. Corp., No. 93 Civ. 3834, 1994 WL 48807 (S.D.N.Y. Feb. 17, 1994).

d. Rights offerings—see In re Nuveen Fund Litig., No. 94 C 360, 1996 WL 328006 (N.D. Ill. June 11, 1996); Strougo v. Scudder, Stevens & Clark, Inc., 964 F. Supp. 783 (S.D.N.Y. 1997); King v. Douglass, 973 F. Supp. 707 (S.D. Tex. 1996).

e. The use of leverage—see Green v. Fund Asset Mgmt., L.P., 19 F. Supp. 2d 227 (D.N.J. 1998); Green v. Fund Asset Mgmt., L.P., 53 F. Supp. 2d 723, 731 (D.N.J. 1999), rev'd, 245 F.3d 214 (3rd Cir. 2001) (Section 36(b) does not preempt state law claims for breach of fiduciary duty and deceit); Green v. Fund Asset Mgmt., L.P., 147 F. Supp. 2d 318 (D.N.J. 2001), aff'd, 286 F.3d 682 (3d Cir.), cert. denied, 537 U.S. 884 (2002); Green v. Nuveen Advisory Corp., 186 F.R.D. 486, 490 (N.D. Ill. 1999); Green v. Nuveen Advisory Corp., No. 97 C 5255, 2001 WL 1035652 (N.D. Ill. Sept. 10, 2001), aff'd, 295 F.3d 738 (7th Cir.), cert. denied, 537 U.S. 1088 (2002).

f. Annuity contracts—see Levy v. Alliance Capital Mgmt. L.P., No. 97 Civ. 4672, 1998 WL 744005 (S.D.N.Y. Oct. 26, 1998), aff'd, 189 F.3d 461 (2d Cir. 1999).

g. The propriety of directors serving on the boards of multiple funds[6]—see Migdal v. Rowe Price-Fleming, No. 98-2162, 1999 WL 104795 (D. Md. Jan. 20, 1999); Migdal v. Rowe Price-Fleming Int'l, No. 98-2162, 2000 WL 350400 (D. Md. Mar. 20, 2000), aff'd, 248 F.3d 321 (4th Cir. 2001); see also Verkouteren v. Blackrock Fin. Mgmt., Inc., 37 F. Supp. 2d 256 (S.D.N.Y. 1999); Verkouteren v. Blackrock Fin. Mgmt., Inc., No. 98 Civ. 4673, 1999 WL 511411 (S.D.N.Y. July 20, 1999), aff'd, 208 F.3d 204 (2d Cir. 2000) (unpublished table opinion); Krantz v. Prudential Invs. Fund Mgmt. LLC, 77 F. Supp. 2d 559 (D.N.J. 1999), aff'd, 305 F.3d 140 (3d Cir. 2002), cert. denied, 537 U.S. 1113 (2003); Strougo v. BEA Assocs., No. 98 Civ. 3725, 1999 WL 147737 (S.D.N.Y. Mar. 18, 1999); Strougo v. BEA Assocs., No. 98 Civ. 3725, 2000 WL 45714 (S.D.N.Y. Jan. 19, 2000); Strougo v. BEA Assocs., 188 F. Supp. 2d 373 (S.D.N.Y. 2002); Krantz v. Fidelity Mgmt. & Research Co., 98 F. Supp. 2d 150 (D. Mass. 2000); Miller v. Mitchell Hutchins Asset Mgmt., Inc., No. 01-CIV-192 (S.D. Ill. Mar. 12, 2002); Nelson v. AIM Advisors, Inc., No. 01-CV-282, 2002 WL 442189 (S.D. Ill. Mar. 8, 2002).

h. Failure to reduce a fund's trading discount—see, e.g., Marquit v. Dobson, Nos. 98 Civ. 9089, 98 Civ. 9059, 98 Civ. 9088, 2000 WL 4155 (S.D.N.Y.), aff'd sub nom. Marquit v. Williams, 229 F.3d 1135 (2d Cir. 2000) (unpublished decision).

i. Payment of membership dues to the ICI—see Rohrbaugh v. Investment Co. Inst., No. Civ. A. 00-1237, 2002 WL 31100821 (D.D.C. July 2, 2002).

j. Fees of underlying funds in "fund of funds"—see Curran v. Principal Mgmt. Corp., No. 4:09-cv-433, 2010 WL 2889752, at *6 (S.D. Iowa June 8, 2010) (concluding Section 36(b) "creates a private right of action for all 'security holders' in the registered investment company, including persons who possess an interest in a mutual fund that is acquired through a fund of funds"), vacated by 2011 WL 223872 (S.D. Iowa Jan. 24, 2011); Sivolella v. AXA Equitable Life Ins. Co., No. 11-4194, 2012 WL 4464040 (D.N.J. Sept. 25, 2012).

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[6] For a discussion of the background which prompted these cases, see James N. Benedict & Mary K. Dulka, "Recent Developments in Litigation Under the Investment Company Act of 1940," Rev. of Sec. & Commodities Reg., Vol. 35, No. 14 (August 2002), at 156-57.

III. CONCLUSION

Although many courts continue to restrict the scope of cases brought under Section 36(b) of the Act, plaintiffs continue to attack conduct with claims under that Section. In light of the Supreme Court's March 30, 2010 decision in Jones v. Harris Associates L.P., which both the industry and the plaintiffs' bar claim as a victory, it is unclear whether plaintiffs will continue to view Section 36(b) as an attractive cause of action in view of the burden of proof imposed upon those seeking to recover. Although the recent filing of "manager of managers" cases suggests that plaintiffs have not yet given up on Section 36(b), Jones should deter plaintiffs from using Section 36(b) as a vehicle to attack conduct beyond excessive fees.

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ERISA Fiduciary Principles and Excessive Fee Litigation

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I. Principal Bases of ERISA Fiduciary and Related Liability

A. Fiduciary liability

1. Duty of Loyalty (ERISA § 404(a)(1)(A)) – Fiduciaries must act *solely in the interest* of plan participants and beneficiaries and for the *exclusive purpose* of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. See, e.g., Eaves v. Penn, 587 F.2d 453 (10th Cir. 1987) (the defendant breached his fiduciary duty when he acquired control of a corporation by buying only a nominal amount of shares himself and then, after converting the company's existing profit-sharing plan into an ESOP, used the ESOP to purchase the balance of the company's stock, which then dramatically declined in value due to his mismanagement).

a. Simply because a plan fiduciary benefits from a transaction does not mean that he has breached the duty of loyalty so long as the decision was prudent and primarily promoted the interest of plan participants and beneficiaries. E.g., Metzler v. Graham, 112 F.3d 207 (5th Cir. 1997) (plan administrator did not breach his fiduciary duty when he caused the plan to purchase land adjacent to his own, thus increasing the value of his land, because there was no evidence the plan administrator placed his own interests above that of the plan's and it actually increased the value of the plan's assets); Donovan v. Walton, 609 F. Supp. 1221, 1245 (S.D. Fla. 1985) (the duty of loyalty under ERISA "does not prohibit a party other than a plan's participants and beneficiaries from benefitting in some measure from a prudent transaction with the plan. Furthermore, by adopting the 'exclusive purpose' standard, Congress did not intend to make illegal the fact of life that most often a transaction benefits both parties involved.").

b. Establishing a breach of the duty of loyalty "requires some showing that the fiduciaries' decisions were motivated by a desire to serve the interests of [the company] over those of the beneficiaries." Tibble v. Edison, No. 2:07-cv-05359, 2010 WL 2757153, at *24 n.19 (C.D. Cal. Jul. 8, 2010), aff'd, 711 F.3d 1061 (9th Cir.), aff'd en banc, 729 F.3d 1110 (9th Cir. 2013).

c. See also the related concept that, subject to certain exceptions, the assets of a plan must never inure to the benefit of an employer (ERISA § 403(c)).

2. Duty of Prudence (ERISA § 404(a)(1)(B)) – Fiduciaries must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with

such matters would use in the conduct of an enterprise of a like character and with like aims.

a. DOL Regulation §2550.404a-1(b)(2) states that the requirements are satisfied in the investment context if the fiduciary: (A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly.

b. Procedural prudence: examines whether the methods by which decisions are made are prudent. See Katsaros v. Cody, 744 F.2d 270 (2d Cir. 1984) (fiduciary breach when a pension fund made a $2 million loan to a bank after relying on a short presentation given by the bank and without obtaining an independent professional appraisal or analysis of the bank or of the collateral); Brock v. Robbins, 830 F.2d 640 (7th Cir. 1987) (even though the court determined that the fee schedule to a service provider was reasonable, the fiduciary breached the duty of prudence by agreeing to the schedule after only a 10-minute discussion and without any study); Zanditon v. Feinstein, 849 F.2d 692 (1st Cir. 1988) (trustee breached duty of prudence by relying on a co-trustee's advice and failing to independently investigate the merits of the plan's investments). These courts have stated that the prudent man rule is a test of the conduct of the fiduciary and not the results. E.g., In re Unisys Savings Plan Litig., 74 F.3d 420 (3d Cir. 1996) and Bussian v. RJR Navisco Inc., 223 F.3d 286 (5th Cir. 2000). A lack of "omniscience and foresight" does not state a claim. White v. Marshall & Ilsley Corp., 714 F.3d 980, 992 (7th Cir. 2013).

c. Substantive prudence: some courts explicitly distinguish between the substantive prudence of a decision and the procedural prudence of the decision. See Kuper v. Iovenko, 66 F.3d 1447, 1459 (6th Cir. 1995) (plan fiduciaries engaged in no process at all, yet the court of appeals affirmed judgment for the plan fiduciaries where the investment was substantively prudent: "a fiduciary's failure to investigate an investment decision *alone* is not sufficient to show that the decision was not reasonable.") (emphasis in original); Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 919 (8th Cir. 1994) ("Even if a trustee failed to conduct an investigation before making a decision, he is insulated from liability if a hypothetical prudent fiduciary would have made the same decision anyway.");

Tatum v. R.J. Reynolds Tobacco Co., 926 F. Supp. 2d 648 (M.D.N.C. 2013), appeal docketed, No. 13-1360 (4th Cir.).

d. There is a presumption of prudence when an ESOP invests in employer securities. In Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995), the Third Circuit stated that an ESOP's fiduciary is "entitled to a presumption that it acted consistently with ERISA" by investing in employer stock. Id. at 571. In order to rebut this presumption, the plaintiff must introduce evidence that "the ERISA fiduciary could not have believed reasonably that continued adherence to the ESOP's direction was in keeping with the settlor's expectations of how a prudent trustee would operate." Id. This holding has been extended beyond ESOPs to any eligible individual account plan holding employer stock, and has been applied at the pleadings stage. See In re Citigroup ERISA Litig., 662 F.3d 128 (2d Cir. 2011); Edgar v. Avaya, Inc., 503 F.3d 340 (3d Cir. 2007). But see Pfiel v. State Street Bank and Trust Co., 671 F.3d 585, 592-593 (6th Cir. 2012) (presumption does not apply at pleading stage).

3. Duty to Diversify (ERISA § 404(a)(1)(C)) – Fiduciaries must diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

a. Burden of proof: once the plaintiff has proven a failure to diversify, the burden shifts to the defendant to prove that such failure to diversify was prudent. Conference Report on ERISA, H.R. No. 93-1280 ("Conf. Report") at 304.

b. Failure to diversify is a facts and circumstances test.

c. The Conf. Report states that "[t]he degree of investment concentration that would violate the requirement to diversify cannot be stated as a true percentage, because a prudent fiduciary must consider the facts and circumstances of each case." The Conf. Report goes on to state that the relevant factors to be considered include (1) the purposes of the plan; (2) the amount of the plan's assets; (3) financial and industrial conditions; (4) the type of investment; (6) the distribution as to geographic location; (6) the distribution as to industry; (7) the dates of maturity. Conf. Rep. at 465.

d. For example, in GIW Indus. Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729 (11th Cir. 1990), the court held that the fiduciary breached the duty to diversify when the fiduciary invested mostly in long-term government bonds with a fixed

maturity date, which later he liquidated at a loss to satisfy cash flow needs.

e. The duty to diversify applies to investments held by each fund in which a plan invests, rather than to all the investments of the plan as a whole. See In re Unisys Savings Plan Litigation, 74 F.3d 420, 438 (3d Cir. 1996) (the duty to diversify must be measured by reference to each individual fund rather than the plan as a whole).

f. The fiduciary must prove both that the decision not to diversify was prudent but also that there was no risk of significant losses. Marshall v. Glass/Metal Association & Glaxers and Glassworkers Pension Plan, 507 F. Supp. 378, 384 (D. Hawaii 1980); See also Etter v. J. Pease Construction Co., 963 F.2d 1005 (7th Cir. 1992) (trustees prudently did not diversify because they conducted extensive research on the investments and the investments provided a 65% annual return).

g. In the case of an eligible individual account plan, the duty to diversify investments is not violated by acquisition or holding of qualifying employer real property or securities. ERISA § 404(a)(2).

4. Duty to Act in Accordance with Plan Documents and Instruments (ERISA § 404(a)(1)(D)).

a. In Donovan v. Cunningham, 716 F2d 1439 (5th Cir. 1983), the court held that the trustee breached his fiduciary duty by failing to excuse himself from a decision as required by the plan documents.

b. The duty is limited to acting in accordance with plan documents and instruments to the extent such documents and instruments are consistent with ERISA. See, e.g., Gruby v. Brady, 838 F. Supp. 820, 829 (S.D.N.Y. 1993) ("if the benefits levels as set forth in the Fund's governing plan documents are excessive, the Trustee Defendants may not avoid their fiduciary duties to Members by hiding behind documents which are inconsistent with ERISA").

c. In In re Citigroup ERISA Litig., 662 F.3d 128 (2d Cir. 2011), cert. denied, 133 S.Ct. 475 (2012), the court held that a plan provision that mandated the holding of a company stock fund was consistent with ERISA's other provisions that explicitly contemplated that eligible individual account plans and ESOPs will invest in employer stock, and therefore following such a plan provision by investing plan assets in employer stock did not run afoul of ERISA § 404(a)(1)(D).

5. Duty not to engage in prohibited transactions (ERISA § 406): ERISA § 406 is intended to make certain transactions per se illegal because of the potential for abuse. See Donovan v. Cunningham, 716 F.2d 1455, 1464-65 (5th Cir. 1983) (the purpose of § 406 "was to make illegal per se the types of transactions that experience had shown to entail a high potential for abuse") and Cutaiar v. Marshall, 590 F. 2d 523 (3d Cir. 1979) ("Congress intended to create an easily applied per se prohibition of the type of transaction in question."). Exemptions to prohibited transactions contained in ERISA § 408, or are issued by DOL pursuant to its authority under Section 408.

a. Prohibition against certain transactions with parties-in-interest:

i. ERISA § 406(a)(1): A fiduciary may not cause the plan to engage in a transaction if he knows or should know that such transaction constitutes a direct or indirect "(A) sale or exchange, or leasing, of any property between the plan and a party in interest; (B) lending of money or other extension of credit between the plan and a party in interest; (C) furnishing of goods, services, or facilities between the plan and a party in interest; (D) transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or (E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of [ERISA § 407(a)]".

ii. A "party-in-interest" is defined in ERISA § 3(14).

b. Prohibition against fiduciary conflicts of interest (ERISA § 406(b))

i. ERISA § 406(b)(1): A fiduciary shall not "deal with the assets of the plan in his own interest or for his own account."

(a) A violation prohibition on self-dealing occurs even if the plan profited from the violation. See Leigh v. Engle, 727 F.2d 113 (7th Cir. 1983) (trustees who were also officers of a company violated § 406(b)(1) when they used plan assets to further the goals of the company even though the plan received a 72 percent return).

(b) It must be shown that the fiduciary dealt with the assets of the plan. See Friend v. Sanwa Bank of California, 35 F.3d 466 (9th Cir. 1991) (a bank serving as a trustee of a plan acted as a creditor and

not a trustee when it refused to renew a line of credit for a company in which the plan invested).

ii. ERISA § 406(b)(2): A fiduciary shall not "in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries."

(a) In Cutaiar v. Marshall, 590 F.2d 523, 529-530 (3d Cir. 1979), the court held that identical trustees of two employee benefit plans violated § 406(b)(2) when they arranged a loan from one plan to the other because a loan transaction necessarily involves "adverse" interests as "…fiduciaries acting on both sides of a loan transaction cannot negotiate the best terms for either plans."

iii. ERISA § 406(b)(3): A fiduciary shall not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."

(a) This is known as the "anti-kickback provision" and does not need a showing of bad faith to find that it has been violated. See Lowen v. Tower Asset Management, Inc., 653 F. Supp. 1542 (S.D.N.Y.), aff'd, 829 F.2d 1209, 1213 (2d Cir. 1987) (quoting Cutaiar, 590 F.2d at 528) ("liability [would] be imposed even where there is 'no taint of scandal, no hint of self-dealing, no trace of bad faith….'"

B. Co-fiduciary liability

1. ERISA § 405(a) provides that a fiduciary may be liable for the breaches of another fiduciary if the first fiduciary "(1) participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach; (2) by his failure to comply with section 404(a)(1) in the administration of his specific responsibilities which give rise to his status as a fiduciary, has enabled such other fiduciary to commit a breach; or (3) has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach."

a. Under ERISA §§ 405(a)(1) or (3), the co-fiduciary must have actual knowledge of the breach. See Davidson v. Cook, 567 F. Supp. 225 (E.D. Va. 1983) (although the fiduciary should have

known about his co-fiduciary's breach, evidence did not indicate that the actual knowledge existed, and therefore, the court refused to impose co-fiduciary liability).

b. A co-fiduciary should take reasonable steps under the circumstances to remedy the breach which, under the circumstances, may include if appropriate, notifying the plan sponsor, or filing a lawsuit or notify the Secretary of Labor. (Conf. Report at 460-61).

C. Non-fiduciary liability – while ERISA does not by its terms extend liability to non-fiduciaries who assist fiduciaries in a breach of duty, courts have extended it to reach such persons.

1. Supreme Court Cases

a. In Mertens v. Hewitt Assocs., 508 U.S. 248 (1993), the Supreme Court avoided the issue of non-fiduciary liability by affirming the lower court's dismissal on the grounds that participants and beneficiaries can seek only equitable relief from non-fiduciaries, which does not include money damages. However, dicta in the decision left open the question of whether non-fiduciaries can be liable for knowing participation in fiduciary breaches.

b. In Harris Trust & Savings Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 251 (2000), the Supreme Court held that a non-fiduciary party in interest could be liable under ERISA § 502(a)(3) for engaging in prohibited transactions, provided the non-fiduciary had "actual or constructive knowledge of the circumstances that rendered the transaction unlawful."

i. It should be noted that there cannot be a prohibited transaction under ERISA § 406 unless there is first a fiduciary who causes the plan to engage in the prohibited transaction. See Wright v. Oregon Metallurgical Corp., 360 F.3d 1090 (9th Cir. 2004) (plaintiffs failed to state a claim when they alleged that the union, which was not a fiduciary, caused the plan to engage in a prohibited transaction).

2. Lower Courts

a. Citing Harris Trust, some courts have extended non-fiduciary liability beyond prohibited transactions. See, e.g., Bombardier Aerospace Employee Welfare Benefit Plan v. Ferrer, Piorot & Wansbrough, 354 F.3d 348, 353-354 (5th Cir. 2003) (ERISA § 502(a)(3) authorizes a cause of action against a non-fiduciary, non party-in-interest attorney because "[a]s Harris Trust makes

clear, an entity need not be acting under a duty imposed by one of ERISA's substantive provisions to be subject to liability under § 502(a)(3).”); Rudowski v. Sheet Metal Workers Int’l Assn. Local Union No. 24, 113 F. Supp. 2d 1176 (S.D. Ohio 2000) (a non-fiduciary may be liable for a fiduciary’s violations of ERISA § 404). But see Renfro v. Unisys Corp., 671 F.3d 314, 325 (3d Cir. 2011) (ERISA does not authorize a suit against “nonfiduciaries charged solely with participating in a fiduciary breach”) (internal citation omitted).

D. Who is a fiduciary?

1. Statute and Regulatory Interpretations

a. ERISA § 3(21)(A) states that “a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.” This includes anyone designated by a named fiduciary to carry out fiduciary responsibilities. The term “person” includes any individual, organization or entity.

b. 29 C.F.R. § 2509.75-8 (Q&A D-3) states that some positions (e.g., plan administrators and trustees) “by their very nature” require persons to perform the fiduciary roles described in ERISA § 3(21)(A).

c. Generally, attorneys, accountants, actuaries or consultants are not considered fiduciaries merely be rendering such services unless it is shown that they are performing a fiduciary function described in ERISA § 3(21)(A). 29 C.F.R. § 2509.75-5 (Q&A D-1).

2. Functional Test – See Mertens v. Hewitt Assocs., 508 U.S. 248, 262 (1993) (statute delineates fiduciary conduct “in functional terms of control and authority over the plan”).

a. A fiduciary is a person that performs any of the functions described in ERISA § 3(21)(A) regardless of their actual role.

b. Those who carry out the basic fiduciary functions relating to asset management, plan administration and investment advice for a fee are generally held to be fiduciaries. See, e.g., Hill v. Blue Cross and Blue Shield of Mich., 409 F.3d 710 (6th Cir. 2005) (a third-

party administrator is a fiduciary when it has discretion to grant or deny claims under the plan).

i. However, those who merely perform ministerial, rather than discretionary, administrative functions are not fiduciaries. 29 C.F.R. § 2509.75-8 (Q&A D-2).

c. Officers of a corporate fiduciary may be considered fiduciaries

i. Some courts have stated that individuals within a corporation or other entity who actually perform the fiduciary functions of the entity gain fiduciary status. See Kayes v. Pacific Lumber Co., 51 F.3d 1449, 1460-1461 (9th Cir. 1995) (a corporate officer who meets the "functional" definition of a fiduciary under ERISA is a fiduciary) and Tittle v. Enron Corp., 284 F. Supp. 2d 511, 569-579 (S.D. Tex. 2003) (an inquiry must be made as to the extent of the responsibility and control actually exercised by particular individuals).

ii. Other courts have held that officers of a corporate fiduciary are not fiduciaries unless it can be shown that they are delegated individual discretionary functions with respect to plan administration. See, e.g., Confer v. Custom Engineering Co., 952 F.2d 34, 36-38 (3d Cir. 1991). See also Holdeman v. Devine, 474 F.3d 770, 778-79 (10th Cir. 2007) (holding that employer does not become a fiduciary simply by breaching an agreement to make employer contributions to an ERISA plan); Arevalo v. Herman, No. 3:OICV512, 2002 U.S. Dist. LEXIS 7076, at *12 (E.D. Va. Apr. 12, 2002) ("A business entity's officer or director who has responsibility for corporate affairs does not also have fiduciary responsibility with regard to an employee benefit plan simply by virtue of that corporate position").

3. Limitations on fiduciary status

a. "To the extent" – ERISA § 3(21)(A) states that a person is a fiduciary only *to the extent* that such person is acting in a fiduciary capacity.

i. For example, the DOL has stated that where the board of directors is "responsible for the selection and retention of plan fiduciaries…their liability is limited to the selection and retention of fiduciaries." DOL Regulation § 2509.75-8 at D-4.

ii. In Pegram v. Herdrich, 120 S. Ct. 2143, 2152 (2000), the Supreme Court stated: "Under ERISA…a fiduciary may have financial interests adverse to beneficiaries. Employers, for example, can be ERISA fiduciaries and still take actions to the disadvantage of employee beneficiaries, when they act as employers (e.g., firing a beneficiary for reasons unrelated to the ERISA plan), or even as plan sponsors (e.g., modifying the terms of the plan as allowed by ERISA to provide less generous benefits)."

iii. In Johnson v. Georgia Pacific Corp., 19 F.3d 1184, 1199 (7th Cir. 1994), the court states that "[a] person is a fiduciary 'to the extent that' he performs one of the described duties; people may be fiduciaries when they do certain things but be entitled to act in their own interest when they do others."

b. Plan sponsors acting as settlors are not fiduciaries in that capacity.

i. Settlor Functions – Courts recognize that employers often wear two hats. The DOL characterizes the non-fiduciary activities as "settlor" functions.

ii. When a plan sponsor adopts, modifies or terminates a plan, it does not act as a fiduciary. See Lockheed Corp. v. Spink, 512 U.S. 882, 891 (1996) (amending a pension plan to include an early retirement window is a settlor function that "does not trigger ERISA's fiduciary provisions").

iii. However, the DOL has acknowledged that while the decision to terminate a plan is a "settlor" function, the actions necessarily taken to effectuate the termination may be fiduciary in nature. (Op. 97-03A (Jan. 23, 1997)). See Varity Corp. v. Howe, 516 U.S. 489 (1996) (an employer acted as a fiduciary when it persuaded employees to voluntarily transfer to a new subsidiary by making misleading communications regarding future benefits).

iv. Courts have generally held that amending a plan is a fiduciary function. See Abbot v. Pipefitters Local Union No. 522 Hospital, Medical and Life Benefit Plan, 94 F.3d 236 (6th Cir. 1996), cert. denied, 519 U.S. 1111 (1997) (multiemployer plan trustees' imposition of higher contribution rate on one group of participants than on other was exercise of fiduciary discretion) and Jacobson v. Hughes Aircraft Co., 105 F.3d 1288 (9th Cir. 1997) (the employer cannot take off its "fiduciary" hat to use for its

own benefit an asset surplus attributable in part to employee contributions).

E. Disclosure Obligations and Fiduciary Duties

1. ERISA §§ 101-111 address explicit ERISA disclosure and reporting obligations.

a. The plan administrator must furnish each participant or beneficiary with specific information, including:

i. a copy of the summary plan description (ERISA § 101(a)(1)); and a summary of material modification to the plan;

ii. the annual report filed with the DOL (ERISA §§ 101(a)(2), 104(b)(3)); and

iii. a statement indicating the total benefits accrued and the nonforfeitable pension benefits, if any, which have accrued, or the earliest date on which benefits will become nonforfeitable (ERISA §§ 101(a)(2), 105(a)).

b. Furthermore, upon written request of any participant or beneficiary, the plan administrator must furnish a copy of the latest summary plan description and the latest annual report, any terminal report, the bargaining agreement, trust agreement, contract, or other instruments under which the plan is established or operated. ERISA § 104(b)(4).

2. Disclosure of non-enumerated material: In Varity Corp. v. Howe, 516 U.S. 489 (1996), the Supreme Court held that a plan sponsor had violated its fiduciary duties under ERISA § 404(a) when it intentionally misrepresented the financial stability of a new subsidiary and persuaded a number of employees to accept a transfer to the subsidiary. The Court specifically did not decide "whether ERISA fiduciaries have any fiduciary duty to disclose truthful information on their own initiative, or in response to employee inquiries." *Id*. at 506. Courts have since addressed, in a number of contexts, whether fiduciary duties may give rise to disclosure obligations beyond those explicitly enumerated in ERISA §§ 101-111.

a. Physician Fee Arrangements: In Ehlmann v. Kaiser Foundation Health Plan of Tex., 198 F.3d 552 (5th Cir.), the Fifth Circuit rejected the argument that a fiduciary has a general duty to disclose the physician fee arrangements of its sponsored health care plan. The Court relied on the principle that specific provisions of a statute govern general provisions in deciding that it would not add disclosure obligations to the specific obligations listed in ERISA

§§ 101-111. The Court declined to address whether disclosure obligations might exist in "special circumstances" or given a "specific inquiry" from a participant. Notably, the Court distinguished the Eighth Circuit's decision in Shea v. Esensten, 107 F.3d 625, as involving "special circumstances." In Shea, the Eighth Circuit held that there was a fiduciary duty to disclose the physician fee arrangement. The Fifth Circuit described Shea as involving special circumstances because, in Shea, "the plan participant asked his doctor whether he should see a heart specialist regarding his heart condition, was told not to, and subsequently died of a heart attack, and…the compensation arrangement discouraged the kind of referral the plan participant sought."

b. Plan Amendments: While courts have generally found no affirmative duty to disclose that changes to a plan are being considered, it is "well-settled that plan fiduciaries may not affirmatively mislead plan participants about changes, effective or under consideration, to employee pension benefit plans." Pocchia v. Nynex Corp., 81 F.3d 275, 278 (8th Cir. 1996) (holding that there is no affirmative duty to disclose proposed changes).

c. Other Cases Finding Additional Disclosure Obligations: Bowerman v. Wal-Mart Stores, Inc., 226 F.3d 574 (7th Cir. 2000) ("[i]f the written materials [are] inadequate, then the fiduciaries themselves must be held responsible for the failure to provide complete and correct material information in the event that a nonfiduciary agent provides misleading information."); Farr v. U.S. West Communications, Inc., 151 F.3d 908 (9th Cir. 1998) ("Defendants' failure to inform Plaintiffs about the potential tax consequences of lump sum distributions constitutes a breach of their fiduciary duties."); Krohn v. Huron Memorial Hosp., 173 F.3d 542, 547-48, 550 (6th Cir. 1999) ("[O]nce an ERISA beneficiary has requested information from an ERISA fiduciary who is aware of the beneficiary's status and situation, the fiduciary has an obligation to convey complete and accurate information material to the beneficiary's circumstance, even if that requires conveying information about which the beneficiary did not specifically inquire.")

d. Cases Finding No Additional Disclosure Obligations: In re Citigroup ERISA Litig., 662 F.3d 128, 143 (2d Cir. 2011) (no "duty to provide participants with nonpublic information pertaining to specific investment options"); Sprague v. General Motors Corp., 133 F.3d 388, 405 (6th Cir. 1998) (noting that "it would be strange indeed if ERISA's fiduciary standards could be used to imply a duty to disclose information that ERISA's detailed

disclosure provisions do not require to be disclosed," and holding that fiduciary did not have an obligation to disclose that the plan was subject to amendment or termination); Faircloth v. Lundy Packing Co., 91 F.3d 648, 657 (4th Cir. 1996) (finding that ERISA § 404(a) did not create duty to disclose employer's appraisal or valuation reports requested by participant).

3. Regulatory initiatives – the Department of Labor has promulgated regulations requiring specific disclosure of fee and investment information:

   a. Service provider disclosure: 29 C.F.R. § 2550.408b-2 requires certain service providers to disclose direct and indirect compensation that the provider expects it or its affiliates to receive in connection with its services, effective July 1, 2012.

   b. Participant disclosure: 29 C.F.R. § 2550.404a-5 requires the plan administrator to disclose, among other things, fees and expenses for general plan administration and the expense ratio, performance, and comparative information for any designated investment alternatives, beginning in 2012.

F. ERISA § 404(c): "if a participant or beneficiary exercises control over the assets in his account…no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control."

1. The Department of Labor has promulgated detailed regulations establishing what a plan must do to take advantage of Section 404(c) protections:

   a. A participant must be able to choose from at least three diversified investment alternatives ("Core Investments"), each of which has materially different risk and return characteristics. 29 C.F.R. §§ 2550.404c-(b)(1)(ii), (b)(3).

   b. A plan must provide participants and beneficiaries with an opportunity to exercise control over assets in his account.

      i. The terms of a plan must provide a reasonable opportunity to give investment instructions. The plan must allow participants and beneficiaries to give investment instructions with a frequency which is appropriate in light of each investment alternative's market volatility, but, in the case of Core Investments, no less than once every three months. 29 C.F.R. § 2550.404c-(b)(2)(ii)(C).

ii. The participant or beneficiary must be provided or have the opportunity to obtain sufficient information to make informed decisions. A participant or beneficiary cannot be deemed to have sufficient information unless:

(a) a fiduciary provides the participant or beneficiary: an explanation that the plan is intended to comply with Section 404(c), a description of the investment alternatives (including the risk and return characteristics of each such alternative), an identification of any designated investment managers, an explanation of when and how a participant or beneficiary may give investment instructions, a description of transaction fees and expenses, the contact information of the plan fiduciary responsible for responding to requests for information, information relating to the procedures established to provide for the confidentiality of holdings, sales, and purchases of employer securities, a copy of the most recent prospectus provided to the plan (for first time investors), and any materials provided to the plan regarding voting, tender or similar rights insofar as such rights pass through to participants or beneficiaries; and

(b) the fiduciary, *upon request*, provides to the participant or beneficiary: a description of the operating expenses of each investment alternative, copies of prospectuses, financial statements, and reports and other materials for investment alternatives, a list of the plan assets comprising the portfolio of each investment alternative and information relating to their value, information concerning the past and current performance and value of shares or units in investment alternatives available to participants or beneficiaries, and information concerning the value of shares or units held in the account of the participant or beneficiary. 29 C.F.R. § 2550.404c-(b)(2)(i)(B).

c. A participant must have in fact exercised independent control with respect to the transaction(s) at issue. Importantly, a participant's or beneficiary's exercise of control is not independent if the fiduciary has concealed material, non-public facts regarding the investment from the participant or beneficiary. 29 C.F.R. § 2550.404c-(c)(2)(ii); see also In re Xerox Corp. ERISA Litig., 483 F. Supp. 2d 206, 213-14 (D. Conn. 2007) (refusing to dismiss employer stock

drop action because plaintiffs alleged that defendants failed to provide them with complete and accurate information regarding the stock); Tyco Int. Ltd MDL, 2004 WL 2903889, *8 (D.N.H. Dec. 2, 2004) (declining to dismiss because fiduciaries may have exercised improper influence or concealed material non-public information); In re Unisys Sav. Plan Litig., 74 F.3d 420, 446 (3d Cir. 1996) (holding, in a case arising before the regulations were effective, that 404(c) applies where the fiduciary provides "complete and accurate information" concerning investment alternatives).

2. The extent of 404(c) protection.

a. The Department of Labor has long asserted that the Section 404(c) defense does not extend to the act of designating investment options, and it codified this view in its disclosure regulations. See 29 C.F.R. § 2550.404c-(d)(2)(iv) (added Oct. 20, 2010 by 75 FR 64910); see also Final Regulation Regarding Participant Directed Individual Account Plans, 57 FR 46906, 46924 n. 27 (Oct. 13, 1992). Thus, according to the Department of Labor, a fiduciary retains liability for the imprudent selection and retention of an investment option on the menu available to participants and beneficiaries. Several courts have deferred to the Department's interpretation, see, e.g., DiFelice v. U.S. Airways Inc., 497 F.3d 410, 423-24 (4th Cir. 2007); Kanawi v. Bechtel Corp., 590 F. Supp. 2d 1213, 1232 (N.D. Cal. 2008); Bendaoud v. Hodgson, 578 F. Supp. 2d 257, 271 (D. Mass. 2008); In re WorldCom, Inc., 263 F. Supp. 2d 745, 763-65 (S.D.N.Y. 2003). Two circuit courts rejected the Department's reading, either explicitly or implicitly, before the Department codified its position in the regulation: See Hecker v. Deere & Co., 556 F.3d 575, 589-91 (7th Cir. 2009); Langbecker v. Elec. Data Sys. Corp., 476 F.3d 299, 310-313 (5th Cir. 2007).

i. Hecker v. Deere & Co., 556 F.3d 575, 589-91, petition for rehearing and rehearing en banc denied, 569 F.3d 708 (7th Cir. 2009). Plaintiffs alleged that Defendants breached fiduciary duties by imprudently providing investment options with excessive fees and by failing to disclose the structure of those fees. Referring to the broad range of investment options (and attendant fees) offered under the plan, the Court dismissed Plaintiffs' complaint on the grounds that participants had control under 404(c) over any losses due to allegedly excessive fees.

ii. Langbecker v. Elec. Data Sys. Corp., 476 F.3d 299, 310-313 (5th Cir. 2007). The court, assuming that the

Department's interpretation was entitled to Chevron deference, nonetheless rejected it. The Court reasoned that the Department's interpretation "would render the § 404(c) defense applicable only where plan managers breached no fiduciary duty, and thus only where it is unnecessary." Id. at 311.

3. Courts also disagree as to whether 404(c) provides a defense to class certification. For cases certifying classes, see, e.g., Merck & Co., Inc. Sec., Derivative & ERISA Litig., 2009 WL 331426, *12-13 (D.N.J. Feb. 10, 2009); George v. Kraft Foods Global, Inc., 251 F.R.D. 338, 349-50 (N.D. Ill. 2008); In re Polaroid ERISA Litig., 240 F.R.D. 65, 76 (S.D.N.Y. 2006). These courts often rely on the reasoning of Lively v. Dynegy, Inc., 2007 WL 685861, *10-11 (S.D. Ill. Mar. 2, 2007), which explained: "the Court fails to see why the defense would be unique to Plaintiffs' claims and would not instead apply to the claims of all of the members of the proposed class, given that it is clearly Defendants' position in this case that they bear no responsibility for the Plan losses at issue here in light of the control Plan participants exercised over the investment of their accounts in…stock." For cases denying certification, see Wiseman v. First Citizens Bank & Trust Co., 212 F.R.D. 482, 486-87 (W.D.N.C. 2003) (denying certification for lack of commonality and typicality because the issue of independent control under 404(c) would require individualized considerations); Thomas v. Aris Corp. of Am., 219 F.R.D. 338, 342 (M.D. Penn. 2003) (denying certification for lack of typicality); see also Langbecker v. Elec. Data Sys. Corp., 476 F.3d 299, 310-313 (5th Cir. 2007) (remanding with instructions that district court consider the effect of 404(c) on the propriety of certification).

4. Consequence of failing to strictly comply with § 404(c) regulations. In Jenkins v. Yager, 444 F.3d 916 (7th Cir. 2006), the plan at issue was not compliant with § 404(c), but the plan had nonetheless provided participants with the ability to choose their investments from a number of options. Plaintiffs argued that the delegation of authority to direct investments, in the absence of compliance with § 404(c), violated fiduciary duties. The Court rejected the Plaintiffs' argument, finding an implied exception to the general rule that a fiduciary may not avoid responsibility by delegating her duties. But see Tittle v. Enron Corp., 2003 WL 22245394, at *24 (S.D. Tex. Sept. 30, 2003) ("If a plan does not qualify as a 404(c) [plan], the fiduciaries retain liability for all investment decisions made, including decisions by the Plan participants.").

G. Remedies under ERISA

1. Causes of action for claims of breach of fiduciary duty:

a. § 502(a)(2) allows the Secretary of Labor, a plan participant, beneficiary or fiduciary to obtain appropriate relief under § 409(a). ERISA § 409(a) provides that "[a]ny person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary."

b. § 502(a)(3) allows a plan participant, beneficiary or fiduciary to bring an action to (i) enjoin any act or practice which violates Title I of ERISA or the terms of the plan or (ii) seek "appropriate equitable relief" in the case of any such violation or to enforce any provisions of Title I of ERISA or the terms of the plan.

c. § 502(a)(1)(B) allows a participant or beneficiary to recover benefits due him under the terms of a plan; typically not viewed as a remedy for breach of fiduciary duty, but some courts have allowed for the possibility that a claim sounding in breach of fiduciary duty may properly be viewed as a claims for benefits. See Lanfear v. Home Depot, 536 F.3d 1217, 1223 (11th Cir. 2008) ("A complaint for the decrease in value of a defined contribution account due to a breach of fiduciary duty is not for damages because it is limited to the difference between the benefits actually received and the benefits that would have been received if the plan management had fulfilled its statutory obligations"). See also LaRue v. DeWolff, Boberg & Association, Inc., 552 U.S. 248, 257 (2008) (Roberts, C.J., concurring) (questioning whether claim was more properly construed as a claim for benefits under ERISA § 502(a)(1)(B)).

2. Relief for individuals vs. relief for the plan as a whole

a. In Varity Corp. v. Howe, 516 U.S. 489 (1996), the Supreme Court held that § 502(a)(3) provided an individual remedy for participants and beneficiaries.

b. For over twenty years, many courts had held that § 409(a) provided relief only to the plan as a whole and not for any entity or plan beneficiary who was harmed, citing Massachusetts Mutual Life Ins. Co. v. Russell, 473 U.S. 134 (1985) (holding that individuals may sue under § 502(a)(2) only on behalf of the plan as a whole).

c. However, the Supreme Court in LaRue v. DeWolff, Boberg & Associates et al., 552 U.S. 248 (2008) distinguished its holding in Russell (which concerned a defined benefit pension plan) where losses were alleged to an individual's account in a defined contribution plan. The Supreme Court stated that "our references to the 'entire plan' in Russell, which accurately reflect the operation of § 409 in the defined benefit context, are beside the point in the defined contribution context." LaRue, 552 U.S. at 256.

d. § 502(a)(3) generally only provides for traditional equitable relief (such as injunctive remedies and monetary remedies such as disgorgement and equitable restitution) and does not allow for "legal" damages.

i. In Mertens v. Hewitt Assocs., 508 U.S. 248 (1993), the Court interpreted the phrase "appropriate equitable relief" in § 502(a)(3) to apply only to "traditional" equitable remedies, such as injunctions and equitable restitution and does not include relief "at law," including legal restitution.

ii. In Great-West Life & Annuity Ins. Co. v. Knudson, 534 U.S. 204 (2002), the Court reaffirmed its holding in Mertens, holding that the plaintiff had not stated a claim for equitable relief under § 502(a)(3). In Great-West, a welfare plan attempted to enforce its subrogation provision and sought reimbursement of medical expenses from a settlement between the plan beneficiary and a third-party tort teaser. However, because the terms of the settlement specifically allocated certain amounts to individuals and entities (including to the plan and a special needs trust) and no part of the settlement went directly into the hands of the plan beneficiary (it went into a special needs trust for the care of the plan beneficiary), the plan was seeking legal restitution (the imposition of personal liability) rather than equitable restitution.

iii. In contrast, in Sereboff v. Mid Atlantic Medical Services, Inc., 547 U.S. 356 (2006), the Court stated that the plaintiff had stated a claim for equitable restitution, which was appropriate under § 502(a)(3). Similar to Great-West, in Sereboff a welfare plan attempted to enforce its subrogation provision. However, unlike Great-West, the Court held that the subrogation provision in Sereboff acted as an equitable lien by contract on the funds recovered by the plan beneficiary and held in a separate account. The Court stated that equitable restitution was appropriate if the basis for the claim and the means used to attain recovery would

have been deemed equitable in the past when there were separate courts of law and equity. Sereboff, 547 U.S. at 362. Since the plan beneficiary had recovered funds from a third-party tortfeasor and had agreed to preserve a portion of the funds in a separate investment account, the Court held that the plan could enforce its subrogation provisions.

iv. However, the Supreme Court has now called into question whether the "equitable" limitation on relief in 502(a)(3) precludes payment of money in forms other than "legal" damages. In Cigna Corp. v. Amara, 131 S.Ct. 1866, 1880 (2011), six Justices agreed that when an ERISA plan beneficiary sues a plan fiduciary, it may be entitled to those remedies previously available in courts of equity. This includes surcharge, "which allows relief in the form of monetary 'compensation' for a loss resulting from a trustee's breach of duty, or to prevent the trustee's unjust enrichment." Id. (citing treatises). The Court explained that "the fact that this relief takes the form of a money payment does not remove it from the category of traditionally equitable relief." Id.

e. Relief under § 502(a)(3) must also be "appropriate."

i. In Varity Corp. v. Howe, the court stated that "where Congress elsewhere provided adequate relief for a beneficiary's injury, there will likely be no need for further equitable relief, in which case such relief normally would not be 'appropriate.'" 516 U.S. 489 (1996). See Ream v. Frey, 107 F.3d 147 (3d Cir. 1997) (a beneficiary could properly recover his account balance from a profit-sharing plan, directly from a breaching fiduciary as "appropriate" equitable relief); Kemmerer v. ICI Americas Inc., 70 F.3d 281 (3d Cir. 1995) (an injunction was the appropriate remedy where the employer terminated a deferred compensation plan and did not distribute account balances pursuant to the participant elections, rather than monetary damages to recover losses on account of adverse tax consequences).

3. Right to a Jury Trial

a. Background

i. ERISA does not expressly create the right to a jury trial.

ii. The Seventh Amendment of the United States Constitution creates a right to a jury trial in "suits at common law."

b. Courts holding that no jury trial is available in an action for benefits under ERISA § 502(a)(1)(B).

i. In Adams v. Cyprus Amax Minerals Co., 149 F.3d 1156 (10th Cir. 1998), the 10th Circuit conducted a Seventh Amendment analysis and concluded that Plaintiffs claims under ERISA § 502(a)(1)(B) were equitable, rather than legal, in nature. Plaintiff had alleged claims for enhanced severance benefits under ERISA. The Court held that claims for recovery of benefits, enforcement of plan terms, and violation of procedural requirements were equitable in nature, turning on "the threshold determination of whether Plaintiffs are eligible to receive assets held in trust by the Defendants" thus "embod[ying] equitable as opposed to legal issues." Id. at 1161. Accordingly, the Seventh Amendment inquiry weighed against a right to a jury trial.

ii. The Adams court further found that even though Plaintiffs had requested monetary relief "an award of money damages may be considered an equitable rather than legal remedy if (1) the monetary award is incidental to or intertwined with injunctive relief or (2) the damages are restitutionary 'such as in actions for disgorgement of improper profits." Adams, 149 F.3d at 1161. In this case, both exceptions applied. Id.

iii. Numerous other courts have held that there is no Seventh Amendment right to a jury trial in actions for benefits under ERISA § 502(a)(1)(B). See DeFelice v. American Int'l Life Assurance Co., 112 F.3d 61, 64-65 (2d Cir. 1997); Blake v. Unionmetal Stock Life Ins. Co., 906 F.2d 1525, 1526-27 (11th Cir. 1990); Cox v. Keystone Carbon Co., 894 F.2d 647, 649-50 (3d Cir. 1990), cert. denied, 498 U.S. 811, 111 S. Ct. 47 (1990); In re Vorpahl, 695 F.2d 318, 320-22 (8th Cir. 1982).

c. Likewise, courts have generally held that there is no right to a jury trial for claims brought under ERISA § 502(a)(3):

i. In Phelps v. C.T Enterprises, Inc., 394 F.3d 213, 222 (4th Cir. 2004), the Court held that where "any potential relief [was] grounded in the 'other equitable relief' language of" ERISA § 502(a)(3) there was no right to a jury trial.

ii. In Spinelli v. Gaughan, 12 F.3d 853, (9th Cir. 1993), the Court found that no right to jury existed for claim under ERISA § 503(a)(3) that Plaintiff was discharged in retaliation for exercising her rights under ERISA. The court relied on both the language of the statute and the Supreme Court's decision in Mertens v. Hewitt Assocs., 113 S. Ct. 2063, 2069 (19993) which held that "damages are not available for a violation of section 502(a)(3)."

d. On the other hand, there is a right to a jury trial in actions for fund contributions against a delinquent employer under ERISA § 502(g)(2). See Sheet Metal Workers Local 19 v. Keystone Heating and Air Conditioning, 934 F.2d 35 (3d Cir. 1991). The court in Keystone Heating relied on the language of Section 502(g)(2)(E), which, unlike other provisions of ERISA authorizes "such other *legal* or equitable relief as the court deems appropriate" (emphasis added). It found that "[t]his choice of terminology reveals that Congress intended to grant the right to a jury trial." Id. at 39.

e. Because claims for breach of fiduciary duty brought under Section 502(a)(2) are generally considered equitable in nature, courts typically find no right to a jury trial, although in a few cases, courts have found that there is a right to a jury trial.

i. For example, in Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005), the court found a right to a jury trial in a breach of fiduciary duty claim where the Trustee [sought] "only to recover funds attributable to [Plaintiff's] loss, not [Defendant's] unjust gain." Id. at 341. As a result, the court concluded that the damages sought were compensatory, and thus a legal claim, rather than restitutionary and thus equitable. See also Ellis v. Rycenga Homes, Inc., 2007 WL 1032367 (W.D. Mich. 2007).

ii. Similarly, in Chao v. Meixner, 2007 WL 4225069 (N.D. Ga., Nov. 27, 2007), the court found that a jury trial was available in a case alleging improper payments made by plan fiduciaries. It reasoned that Section 502(a)(2) "does not expressly limit the available remedies to equitable remedies, and expressly authorizes remedies *compensatory* in nature, which traditionally arise at law."

II. Excessive Fee Cases

A. Overview

1. Dozens of putative class action lawsuits filed in the last three years allege that 401(k) plans are being charged excessive fees in breach of ERISA fiduciary duties owed to plans and plan participants.

2. Claims are asserted by two types of plaintiffs:

    a. Individual plan participants on behalf of themselves and a putative class of participants of the plan(s) sponsored by a single employer; or

    b. Plan named fiduciaries on behalf of their plans and a putative class of fiduciaries of plans serviced by the same provider.

3. Defendants named in the suits include:

    a. Employer-sponsor and plan's named fiduciaries; and/or

    b. Plan service providers including directed trustee, recordkeeper and/or investment provider.

4. Core allegations include:

    a. Defendants caused the plan to pay unreasonable fees in the form of direct and indirect compensation to service providers in violation of ERISA § 404(a) prudence requirements and ERISA § 406 prohibited transaction rules.

    b. Defendants engaged in an imprudent investment selection process that resulted in the inclusion of excessively-priced investment vehicles, causing the plan to pay excessive fees.

    c. Defendants suffered from conflicts of interest in selecting providers and negotiating fees.

    d. Defendants failed to monitor fees and expenses paid by the plan and investment option performance.

    e. Defendants failed to disclose revenue sharing arrangements between service provides to plan sponsors and participants.

    f. Defendants use of asset-based fee structures caused participants to pay excessive fees.

    g. Defendants engaged in self dealing by using plan assets, including revenue sharing payments and float earned on plan investments, for their own benefit.

B. Decisions in lower courts

1. Some defendants have succeeded in defeating excessive fee claims at the motion to dismiss stage.

   a. In Hecker v. Deere & Co., 556 F.3d 575, *petition for rehearing and rehearing en banc denied*, 569 F.3d 708 (7th Cir. 2009), the Seventh Circuit affirmed dismissal of the complaint in this first appellate decision in the wave of participant-filed excessive fees suits on the grounds that defendants had breached no fiduciary duty based on the alleged failure to disclose revenue sharing between service providers, and that the complaint's allegations did not state a claim that the employer acted imprudently in selecting investment funds for the plans. The court also affirmed dismissal of the claims against the two service provider defendants, finding that neither possessed relevant fiduciary authority such that either could be liable under ERISA for disclosing revenue sharing practices or choosing investment options. In rejecting plaintiffs' core allegations that the funds in the plans charged excessively high fees, the court relied, in part, on the fact that mutual fund fees are set in a competitive market and that the plans at issue offered funds with a wide range of fees, including 2,500 funds that were accessible through a brokerage window.

   b. The court in Columbia Air Servs. Inc. v. Fidelity Management Trust Co., No. 07-11344, 2008 WL 4457861 (D. Mass. Sept. 30, 2008) dismissed the plaintiff's complaint in a fiduciary-filed suit that challenged the fees and revenue sharing payments received by the plan's directed trustee and recordkeeper, finding that plaintiff failed to allege facts that defendant acted as a fiduciary of the plan with respect to its contractual compensation and receipt of revenue sharing payments from fees collected from affiliated mutual funds.

2. Of the cases that have proceeded past the motion to dismiss stage, some defendants have prevailed on summary judgment.

   a. Defendants in Taylor v. United Tech. Corp. et al., No. 06-1494, 2009 WL 535779 (D. Conn. March 3, 2009), aff'd, 354 Fed. Appx. 525 (2d Cir. Dec. 1, 2009), obtained summary judgment on the eve of trial on similar claims of imprudent investment selection and excessive and undisclosed fees. The court rejected plaintiffs' challenge to the plan's use of actively-managed mutual funds, noting that in some instances the plan's active funds outperformed their index benchmarks, and that in any event the defendant sponsor's fund selection process included appropriate consideration of the fees and returns of the selected funds. The court also rejected plaintiffs' excessive fees claim, where plaintiffs failed to proffer evidence to show that the plan's service provider

received compensation that was "materially unreasonable" or "beyond the market rate."

b. Defendants in Kanawi v. Bechtel Corp., No. 06-05566 (N.D. Ca. Nov. 3, 2008), also obtained summary judgment on plaintiffs' excessive fees claim when the court held that the evidence did not support a determination that the fees paid by the plan were "patently unreasonable," or that defendants abrogated their duties in reviewing the performance of the funds. Declining to second-guess defendants' business judgment or to rely solely on hindsight, the court noted that "the test of prudence is one of conduct and not performance." With respect to plaintiffs' claim that defendants engaged in prohibited transactions by retaining an investment manager and service provider who lacked independence, the court dismissed that claim to the extent that the challenged fees were paid by the employer and plan sponsor, and not out of plan assets, leaving only plaintiffs' claim with respect to a four-month period during which the fees were paid from plan assets. The Department of Labor has intervened in the district court to be permitted to obtain the summary judgment record in the event an appeal is taken and the Department wishes to participate at the appellate level.

3. Plaintiffs' claims have survived early challenges on the pleadings in several instances, and have been found partially meritorious in one trial.

a. In Braden v. Wal-Mart Stores, Inc., 588 F.3d 585 (8th Cir. 2009), the court reversed dismissal of claims against the plan's employer-sponsor and named fiduciaries that alleged, among other things, excessive and undisclosed fees and imprudent selection of the plan's mutual fund options, which included ten retail class funds, most of which were actively managed. The court found that plaintiffs stated excessive fee claims by alleging (i) provider received undisclosed revenue sharing; (ii) mutual funds offered charged significantly higher fees than alternatives; (iii) revenue sharing was an alleged "kickback."

b. The court in Spano v. The Boeing Co., 2007 WL 1149192 (S.D. Ill. Apr. 18, 2007) also denied defendants' motions to dismiss, declining to decide whether the plan sponsor and its benefits director were fiduciaries of the plan within the meaning of ERISA, whether fiduciary status is a factual question the court deemed inappropriate for a motion to dismiss. The court also declined to decide on the pleadings whether the relief the plaintiffs sought was equitable within the meaning of § 502(a)(3) and held that the defendants' ability to maintain a defense under § 404(c) could not be decided on the complaint.

c. In Tussey v. ABB, Inc., 2008 WL 379666 (W.D. Mo. Feb. 11, 2008), the court held that neither ERISA nor the Department of Labor require that revenue sharing be specifically identified and disclosed to participants, and that defendants could therefore not have breached duties owed to participants by failing to disclose revenue sharing arrangements between service providers. Nonetheless, the court denied the sponsor's motion to dismiss based on § 404(c) on the ground that § 404(c) is an affirmative defense that must be pleaded and proved at trial. As to the service provider defendants' motions to dismiss, the court held that the complaint raised factual questions as to the providers' discretion over plan assets for purposes of determining fiduciary status, and that it was inappropriate to make that factual determination on the pleadings, denying the motions. After a full trial on the merits, 2012 WL 1113291 (W.D. Mo. Mar. 31 2012), appeal pending, the court held that the plan sponsor failed to quantify/monitor recordkeeping fees and revenue sharing, and failed to capture revenue sharing for plan benefit and acted imprudently with respect to certain investment selections. The provider not liable for investment selection because it was not a fiduciary with respect to its fees.

4. Plaintiffs have also obtained victories at the summary judgment stage.

a. In Haddock v. Nationwide Financial Services, 419 F. Supp. 2d 156 (D. Conn. 2006), the trustees of five separate defined contribution plans sued Nationwide for ERISA violations based on allegations of excessive mutual fund revenue sharing payments. In March 2006, a federal district court denied Nationwide's motion for summary judgment holding that material facts existed as to whether (1) Nationwide's status as the plan's investment provider made it a "fiduciary" and (2) the funds used for revenue sharing payments constituted "assets of the plan."

5. Class certification decisions

a. Classes have been certified in a number of cases, including Abbott v. Lockheed Martin Corp., Tussey v. ABB, Inc., Taylor v. United Tech. Corp. et al., but denied in cases including Spano v. The Boeing Co., Northrup Grumman Corp., Civ. A. No. 2:06-CV-06213 (C.D. Cal.) and Ruppert v. Principal Life Ins. Co., Civ. A. No. 4:07-CV-00344 (S.D. Ia.).

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GOODWIN PROCTER ALERT

SEPTEMBER 26, 2013

In *Pipefitters*, Sixth Circuit Holds Service Provider Is Fiduciary in Assessing Fee

In *Pipefitters Local 636 Insurance Fund v. Blue Cross and Blue Shield of Michigan*, No. 12-2265, 2013 WL 3746217 (July 18, 2013), the U.S. Court of Appeals for the Sixth Circuit held that an entity providing services to a plan acts as an ERISA fiduciary where it exercises discretion to determine and assess a fee paid by the plan to the service provider.

Background

In *Pipefitters*, a self-funded health plan entered into an administrative services contract ("ASC") with Blue Cross and Blue Shield of Michigan ("BCBSM"), under which BCBSM would provide certain services to the plan and the plan would be responsible for paying benefit claims and specified fees. The ASC also provided that "any cost transfer subsidies . . . ordered by [the relevant state insurance commission] will be reflected in the hospital claims cost" payable by the plan.

Under applicable state law, BCBSM was required to pay 1% of its revenues to the state to subsidize the cost of health care to senior citizens in the state receiving "Medigap" coverage (the "Medigap Obligation"), but state law did not prescribe the method by which BCBSM was to satisfy this Medigap Obligation.

During the first 18 months that the ASC was in effect, BCBSM undertook to obtain funds to satisfy the Medigap Obligation by, in effect, charging and retaining 1% of the cost of benefit claims it paid on behalf of the plan, with the amount retained referred to as the "OTG Fee." (For example, on a $100 claim, BCBSM would charge the plan $101, pay the health care provider $100, and retain $1 as an OTG Fee to pay the Medigap Obligation.) After 18 months, BCBSM unilaterally decided to stop charging the OTG Fee.

District and Appeals Court Decisions in *Pipefitters*

The Pipefitters plan sued BCBSM, asserting that BCBSM acted as an ERISA fiduciary in determining and assessing the OTG Fee. The plan argued that, in causing the plan to pay the OTG Fee, BCBSM had breached its fiduciary duties of prudence and loyalty and had engaged in prohibited self-dealing. After the district court granted summary judgment for the plan, BCBSM appealed.

The Sixth Circuit affirmed in a unanimous decision. The court noted that while state law imposed the Medigap Obligation on BCBSM, the method of obtaining funds to pay that obligation was left to the discretion of BCBSM. The court rejected BCBSM's argument that the method BCBSM decided to use – the OTG Fee – was compelled by the terms of the ASC which provided that state-required "cost transfer subsidies" would be reflected in the costs of claims paid by the plan.

The court emphasized that BCBSM had not assessed the OTG Fee against all of its self-funded plan customers, and had unilaterally decided to stop assessing the fee against the Pipefitters plan. Because its discretionary assessment of the fee against the plan benefitted BCBSM (by helping it to fund its Medigap Obligation), the court concluded that BCBSM had breached its fiduciary duties under ERISA.

In *Edmonson*, Third Circuit Affirms Summary Judgment for Insurer in Retained Asset Account Case

In *Edmonson v. Lincoln National Life Insurance Company*, No. 12-1581, 2013 WL 4007553 (Aug. 7, 2013), the U.S. Court of Appeals for the Third Circuit affirmed summary judgment for the defendant insurance company in one of the many cases challenging the use in group insurance benefit plans of retained asset accounts.

Background

The litigation was brought by a beneficiary of a group life insurance plan whose sponsor had purchased group life insurance contracts from the insurer defendant. The insurer paid benefit claims under the group contract through interest-bearing accounts backed by funds that the insurer retained until the account holders wrote checks or drafts against the account. The plaintiff challenged the practice, which she claimed constituted a breach of fiduciary duty and a prohibited transaction under ERISA. The plaintiff purported to sue on behalf of a class of beneficiaries under contracts issued by the insurer defendant who had received their benefits through a retained asset account.

District and Appeals Court Decisions in *Edmonson*

In February 2012, the U.S. District Court for the Eastern District of Pennsylvania entered an order granting judgment to the defendant on the grounds that assets backing the retained asset accounts were not plan assets and the defendant was not acting as an ERISA fiduciary with respect to the plan.

On appeal, the Third Circuit ruled in favor of the defendant, albeit on somewhat different grounds. With respect to the plaintiff's claim that the defendant exercised fiduciary discretion in selecting the method of claims payment, the court held the insurer to be an ERISA fiduciary with respect to plan administration and management because the plan at issue permitted the insurer "some leeway" to decide how claims would be paid, and therefore conferred discretion upon it.

The court also held that the insurer's selection of the method of claims payment involved exercising authority or control over a plan asset – the policy. However, while the court held the insurer to fiduciary standards with respect to its selection of the method of payment, the court nonetheless concluded that the insurer did not breach its fiduciary duty of loyalty when it chose to settle claims via retained asset accounts because such accounts are not inconsistent with the beneficiary's interests and the insurer's potential to profit was "wholly dependent" on the beneficiaries' actions. The court noted that ERISA does not mandate nor preclude any specific mode of payment.

Fiduciary Status and Standing

With respect to the plaintiff's claim concerning the defendant's investment of retained assets, the court held that the defendant was not a fiduciary with respect to that conduct because retained assets are not ERISA plan assets.

In addition to its fiduciary analysis, the court also addressed issues of constitutional and statutory standing, ruling that the plaintiff had both constitutional and statutory standing to assert her claims in light of her allegations that (i) she suffered an alleged injury in fact with respect to any difference between the defendant's investment earnings on retained assets and the crediting rate paid on retained asset accounts; (ii) her alleged injury was traceable to the defendant's decision to settle benefit claims via retained asset accounts; and (iii) ERISA's equitable relief provision afforded her a claim for disgorgement of ill-gotten profits.

One member of the three-judge panel expressed disagreement with these standing rulings in an opinion that dissented from that portion of the majority opinion, but otherwise joined the majority in affirming judgment for the defendant. With respect to whether the plaintiff suffered any actual injury, in affirming judgment for the defendant on the merits, the court concluded

"[p]ayment via the retained asset account, by itself, caused [the plaintiff] no injury," because the plaintiff "could have … withdraw[n]" the funds from the account at any time.

In *Abbott*, Seventh Circuit Refines Applicability of Class Action Device in Defined Contribution Challenge

On August 7, 2013, the U.S. Court of Appeals for the Seventh Circuit took what it called "the next step" in its analysis of when a class may be certified in a case alleging breach of ERISA fiduciary duties with respect to a defined contribution plan, after it first addressed the question in its January 2011 decision, *Spano v. Boeing Co.*, reported in Goodwin Procter's March 30, 2011 ERISA Litigation Update. In *Abbott v. Lockheed Martin Corporation*, No. 12-3736, 2013 WL 4010226, a panel comprised of the same judges who decided the *Spano* case reversed denial of a class that was "more focused" than the one it rejected in *Spano*, and remanded the case to the trial court, allowing a class of 401(k) participants who invested in a single fund available under their plan to proceed to trial.

Background

Abbott is one of many cases challenging the fees associated with 401(k) plan investments. Through a number of previous rulings, the district court had narrowed the case down to three claims: (i) the administrative fees paid by the plan were excessive; (ii) the stable value fund investment option was imprudently managed resulting in underperformance, and (iii) the company stock fund investment option was imprudently managed due to allegedly excessive fees and a high level of cash held in the fund. The trial court had once before certified a class, though the decision had been remanded by the Seventh Circuit in 2011 based on *Spano v. Boeing*. After *Spano*, the trial court again ruled on class certification, with one of the classes it declined to certify receiving interlocutory review by the Seventh Circuit.

The Trial Court Decision as to the Challenged Class

After remand, the trial court certified two classes, one with respect to the administrative fee claim and a second with respect to the stock fund. However, it declined to certify a third class of participants who invested in the stable value fund during a six-year period when the fund underperformed relative to a specified index. The court below had held that, in attempting to navigate the Seventh Circuit's earlier *Spano* decision, the plaintiffs created a fatal issue – asking the court to use the class certification mechanism to "backdoor" the contested question of underperformance with their chosen benchmark. Because the trial court had not ruled substantively on whether such alleged underperformance constituted any breach of duty, it declined to certify the stable value class.

In its decision, the Seventh Circuit addressed only the stable value proposed class.

The Seventh Circuit Finds That Certification Was Appropriate

Preliminary to its discussion of class certification, the Seventh Circuit rejected the defendants' challenge to the constitutional standing of the sole named plaintiff who was invested in the stable value fund – and whose account outperformed the index he selected – holding that there could be harm aside from underperformance with the index.

Turning to the class issues, the appellate court held that simply allowing a class definition that makes reference to underperformance of a fund to an index is not tantamount to accepting that the index is the proper measure of harm or breach. The court observed that the class definition is simply a "tool of case management" and does not, as defendants contended, "sneak into the case a theory of liability that was rejected at summary judgment."

The court went on to explain why certification of the single, stable value fund class was consistent with *Spano*. It explained that the class in *Spano* was not limited to a single fund and, indeed, it was not apparent from the complaint in *Spano* which fund(s) were challenged "or why." The Seventh Circuit explained that *Spano* stood for the proposition that a combination of a broad class and vague claims would inevitably create "intra-class conflict of the sort that defeats both typicality and adequacy-of-representation requirements" of the Federal Rules of Civil Procedure 23(a). It found, by contrast, that the class in *Abbott* was "considerably narrower than those at issue in *Spano*" and that the nature of stable value funds were such that there was little risk that some investors would reap a windfall by mismanagement such that a conflict would exist for a class comprised solely of investors in a stable value fund.

Postscript on *Spano*

On September 19, 2013, six weeks after *Abbott* was decided by the Seventh Circuit, the district court in *Spano* granted in part the plaintiffs' amended motion for class certification, and certified a class and four sub-classes. The class was comprised, again, of all plan participants, but was limited to a six-year period and specified that all participants paid recordkeeping fees. One subclass was comprised of participants in all mutual funds during that period under the theory that every fund was "laden with imprudently excessive fees," and the three remaining sub-classes corresponded to individual fund choices for

GOODWIN PROCTER ALERT

JUNE 27, 2013

In *PBGC*, Second Circuit Affirms Dismissal of Prudence Claims Despite Allegations of Investment Losses

In *PBGC. v. Morgan Stanley Investment Management, Inc.*, No. 10-4497-cv (April 2, 2013), the Second Circuit held that a complaint's allegations of "a decline in a security's market price does not, by itself, give rise to a reasonable inference that the holding of the security was or is imprudent." The court concluded that an ERISA complaint asserting imprudence regarding plan investments in securities must plausibly allege that the process utilized by the relevant fiduciary in deciding to acquire and hold the securities was imprudent.

District Court Decision in *PBGC*

As described in our analysis of the district court opinion, in *PBGC* a plan sponsor claimed that the manager of the plan's fixed-income portfolio had imprudently caused the plan to invest excessively in securities backed by subprime mortgages. When the value of those securities dropped following the subprime real estate crash in 2007 and 2008, the portfolio allegedly lost $25 million. (The Pension Benefit Guaranty Corporation ("PBGC") was substituted as appellant after the plan was terminated and assumed by the PBGC.) The district court dismissed the plan sponsor's complaint, reasoning that under ERISA a fiduciary's "actions are not to be judged from the vantage point of hindsight."

The Test for Prudence

In affirming that dismissal, the Second Circuit emphasized that the test for prudence focuses on process rather than simply investment results. The court of appeals noted that, because the complaint contained no allegations directly relating to the manager's "knowledge, methods, or investigations" regarding the challenged investments, it could survive a motion to dismiss under FRCP 12(b)(6) only if it alleged facts and circumstances that gave rise to a reasonable inference that an adequate investigation would have revealed to a reasonable fiduciary that the investment at issue was improvident.

According to the court, this standard could be satisfied by allegations showing that the relevant investments were "so plainly risky" that appropriate investigation would have revealed their imprudence, or that an adequate review would have uncovered a "readily apparent" superior alternative investment.

The Second Circuit ruled that the complaint in *PBGC* failed to meet this standard. The court noted that PBGC pointed to certain "warning signs" regarding the relevant securities alleged in the complaint – e.g., that some issuers of the securities disclosed large losses in 2007 and 2008. The complaint, however, "fail[ed] to connect the alleged 'warning signs' to any specific characteristics of the securities in the [plan's fixed-income] portfolio."

In *Leimkuehler*, Seventh Circuit Affirms Judgment for Insurer in Challenge to Use of Separate Accounts in 401(k) Platform

In *Leimkuehler v. Am. United Life Ins. Co.*, Nos. 12-1081, 12-1213, & 12-2536 (Apr. 16, 2013), the Seventh Circuit affirmed dismissal, on summary judgment, of all claims against an insurer concerning the investment options offered to a retirement plan on a platform structured through separate accounts within group annuity contracts sold to the plan's trustees.

Background

The trustee of a 401(k) plan sued the insurer providing investment and recordkeeping services to the plan through a group variable annuity contract. Suit was brought on behalf of the plan and a purported class of all other plans that purchased the insurer's variable group annuity product. The trustee claimed that the insurer breached its alleged ERISA fiduciary duty and committed a prohibited transaction by establishing and operating the platform and receiving revenue sharing payments from mutual funds (or affiliates of the funds) held in separate accounts and made available to the insurer's customers through its group variable annuity contracts under the platform.

District Court Decision in *Leimkuehler*

The U.S. District Court for the District of Indiana granted the insurer summary judgment on the claims, holding that the insurer was not acting as a fiduciary under ERISA in establishing and operating the platform through which it received revenue sharing. The Seventh Circuit affirmed the judgment of the district court and held that an insurer was not acting as an ERISA fiduciary in structuring the platform and could therefore not be liable for breach of ERISA fiduciary duty or prohibited transactions in receiving the revenue sharing payments.

ERISA Fiduciary Status

The Seventh Circuit confirmed that the creation of a menu of funds as part of a product offering to retirement plan trustees does not give rise to ERISA fiduciary status. It also expressly held that ERISA's fiduciary status analysis is not altered merely because the insurer established and maintained separate accounts to hold specified mutual funds.

While an insurer may be an ERISA fiduciary as to the actual operation of such separate accounts, the court held that it can only be liable if it "mismanaged the separate account—say, by losing track of participants' contributions or withdrawing funds in the separate account to pay for a company-wide vacation to Las Vegas."

The court also expressly rejected arguments made in an amicus curiae brief submitted by the Department of Labor, and held that an insurer's contractual ability to substitute funds did not give rise to fiduciary status with respect to all of the investments that the insurer includes on its product platform.

In *McCutchen*, Supreme Court Vacates and Remands Case Concerning Enforcement of Plan Reimbursement Provision

In *U.S. Airways, Inc. v. McCutchen*, No. 11-1285 (Apr. 16, 2013), the U.S. Supreme Court vacated judgment and remanded the case in a matter seeking to enforce a reimbursement provision in a health benefit plan.

Background

The case involved a self-funded group health plan. The plan provided coverage for medical expenses that were not covered by a third party. Under the plan, if benefits were paid on a claim resulting from the actions of a third party, the participant would be required to reimburse the plan for amounts paid for claims out of any monies recovered from any third party (including an insurer).

McCutchen was injured in a car accident caused by another driver. The plan paid $66,866 in healthcare benefits in connection with McCutchen's injuries. McCutchen pursued claims against his automobile insurer and the other driver and ultimately

recovered $110,000 by way of settlement. After attorney's fees, McCutchen recovered $66,000. The employer demanded reimbursement of 100% of the benefits paid under the plan. When McCutchen refused, the employer brought suit under ERISA § 502(a)(3), seeking equitable relief in the form of a lien on the $66,866 it demanded.

District and Appeals Court Decisions in *McCutchen*

The U.S. District Court for the Western District of Pennsylvania found for the employer on the ground that the plan "clear[ly] and unambiguous[ly]" provided for full reimbursement of medical expenses paid, and ordered McCutchen to pay the employer $66,866.

On appeal, the Third Circuit vacated. Reasoning that traditional "equitable doctrines and defenses" applied to § 502(a)(3) suits, the Third Circuit held that the principle of unjust enrichment overrode the plan's reimbursement provision because it would be a windfall for the employer to recover its entire lien amount without paying a share of attorney's fees. The appeals court stated that Congress's use of the term "appropriate equitable relief" in the statute was intended to allow defenses typically available in equity, such as unjust enrichment.

Equitable Defense vs. ERISA Plan Reimbursement

The Supreme Court granted certiorari to resolve a circuit split on whether equitable defenses can override an ERISA plan's reimbursement provision. The Court vacated the Third Circuit's decision, ruling that a participant who receives medical payments for an injury pursuant to an ERISA health benefit plan may not avoid the reimbursement requirements of that plan by arguing that such reimbursement is "inequitable."

In so ruling, the Court pointed to its decision in *Sereboff v. Mid Atlantic Medical Services, Inc.*, 547 U.S. 356 (2006), in which the Court permitted a health plan administrator to bring suit under § 502(a)(3) to enforce a reimbursement clause. The Court held that, under *Sereboff*, the equitable doctrine of unjust enrichment could not override the terms of the plan, which afforded the employer an "equitable lien by agreement" on amounts recovered by the participant from a third party.

The Court stated that enforcing such a lien means holding the parties to their mutual promises and declining to apply equitable principles that are at odds with the parties' expressed commitments. Rejecting McCutchen's argument that § 502(a)(3) authorizes broad equitable relief, the Court held that the statute does not "authorize 'appropriate equitable relief' *at large*," but provides only such relief as will enforce "the terms of the plan" or the statute.

Nonetheless, while the Court held that equitable principles could not trump the plan's reimbursement provision, it also concluded that – where the plan was silent on the allocation of attorney's fees – equitable principles could inform how attorney's fees expended by McCutchen should be allocated among the parties. Accordingly, the Court remanded the case for further proceedings on the attorney's fee issue.

GOODWIN PROCTER ALERT

MARCH 28, 2013

Ninth Circuit Addresses Numerous ERISA Issues in Affirming District Court's Rulings in *Tibble* Case

In *Tibble v. Edison International*, Nos. 10-56406, 10-56415, 2013 WL 1174167, No. 11-56628, 2013 WL 1150788 (9th Cir. Mar. 21, 2013), participants in a 401(k) plan brought a class action against the employer sponsoring the plan (and various individuals and entities affiliated with the employer), asserting that the selection of investment options made available to them under the plan violated ERISA fiduciary requirements. As we previously reported in the September 2010 ERISA Litigation update, available here, the U.S. District Court for the Central District of California had dismissed most of the participants' claims, but (after a bench trial) held that the defendants had breached their duty of prudence under ERISA by including within the plan's investment menu the retail class shares, rather than the institutional class shares, of three specific mutual funds, absent any evidence that the defendants considered the alternative share classes or that the plan benefitted from the retail share classes. In reviewing the district court's rulings, the U.S. Court of Appeals for the Ninth Circuit addressed a number of ERISA issues that frequently arise in litigation challenging the selection of investment options for participant-directed investment plans.

The Court of Appeals affirmed the district court's holding that claims challenging the inclusion of investment options first selected for the plan's menu more than six years before the filing of the complaint were barred by ERISA's statute of limitations – which, in pertinent part, provides that ERISA fiduciary breach claims may not be brought "more than six years after the last action that constituted part of the breach." ERISA § 413(1)(A). The court rejected the "continuing violation theory" advanced by the plaintiffs and the Department of Labor as amicus curiae ("DOL"), under which the claims would be timely so long as the investment options in question remained available under the plan during the six year limitations period. The court concluded that such a result "would make hash out of ERISA's limitation period and lead to an unworkable result."

The defendants did not fare as well in seeking dismissal, on statute of limitations grounds, of claims challenging the inclusion of certain options utilizing mutual fund retail class shares that were added to the plan's menu less than six years, but more than three years, before commencement of the action. The defendants argued that these claims were barred by the ERISA statute of limitations provision that precludes claims brought more than "three years after the earliest date on which the plaintiff had actual knowledge of the breach." ERISA § 413(2). According to the panel of the Ninth Circuit, the "breach" with regard to the claims involving the retail shares was not based simply on their inclusion in the plan's investment menu, but focused rather on the defendants' failure to investigate alternatives to offering retail shares as an option. Because the evidence did not establish that the plaintiffs had – more than three years before the filing of the complaint – "actual knowledge" of the defendants' process of selecting the retail shares as an option, and their failure to investigate alternatives, the three-year statute did not bar those claims.

The defendants also argued that the participants' claims challenging the selection of investment options were proscribed by ERISA § 404(c), which provides a safe harbor from fiduciary liability in cases where participants exercise investment control over their defined contribution plan accounts, and certain conditions are satisfied. The Ninth Circuit noted, however, that under the relevant DOL regulation the Section 404(c) safe harbor protects fiduciaries from liability only from losses that are the "direct and necessary result" of the participants' exercise of control, *see* 29 C.F.R. § 2550.404c-1(d)(2), and that the DOL had specifically stated in the regulation's preamble that a fiduciary's selection of investment options is not a direct or necessary result of a participant's investment direction. The Court of Appeals concluded that the position of the DOL stated in the preamble (and reiterated by the DOL consistently since the adoption of the regulation) was an interpretation of Section 404(c) that is entitled to "Chevron deference," *see Chevron, U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837

(1984). Because the court found the statutory language of Section 404(c) ambiguous, and the DOL's position to be reasonable, it held that the safe harbor from fiduciary liability did not cover the defendants' selection of the retail class shares as an option for the plan's investment menu.

The plaintiffs prevailed on the merits of their retail class share claims relating to three specific mutual funds. The Ninth Circuit affirmed the district court's holding that the defendants had breached their duty of prudence under ERISA § 404(a)(1) when, without sufficient investigation, they selected for the plan's investment menu retail class shares of funds that also offered institutional class shares, even though there were no meaningful differences in the investment quality or management of the fund when purchasing the institutional shares rather than the retail shares, and the fees and expenses associated with the retail shares were 24 to 40 basis points more expensive than those of the institutional shares. The court rejected the defendants' argument that they reasonably relied on their investment consultant in selecting the retail shares, because there was "an utter lack of evidence that [the defendants] considered the possibility of institutional classes for the [relevant] funds" and the defendants presented no evidence that their consultant had specifically recommended investment in retail shares. The court below, and the appellate court, did not address in this context the benefits to the plan of use of revenue sharing through these funds to reduce or eliminate other plan expenses.

The participants failed, however, in their general challenge to the use of revenue sharing payments made by the plan's investment options to compensate the plan's recordkeeper. They argued that this practice violated a plan provision stating that "[t]he cost of the administration of the Plan will be paid by [the sponsoring employer]." They also asserted that the defendants violated ERISA's anti-kickback provision – Section 406(b)(3) – by selecting investment options that paid revenue sharing which reduced the employer's obligation to pay the plan's administrative expenses. The court noted, however, that the plan's benefits committee had discretion under the plan to construe its terms, and that the committee had interpreted the relevant plan language as obligating the employer to pay plan administrative costs "net of any adjustments" such as revenue sharing. The court found this interpretation of plan language entitled to deference under *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989) and its progeny, and therefore held that the use of revenue sharing to compensate the recordkeeper (and to reduce the employer's costs) violated neither the plan document nor ERISA § 406(b)(3).

The Ninth Circuit also affirmed the district court's dismissal of the participants' remaining claims, including: claims that the defendants violated their duty of prudence by including mutual funds (rather than only collective funds or single plan separate accounts) in the plan's investment menu; claims that the mutual funds made available under the plan charged excessive fees; a claim that the selection of a short-term investment fund ("STIF"), rather than a stable value fund, was imprudent; and a prudence challenge to the plan's use of a "unitized" employer stock fund (rather than direct investment in employer stock). Significantly, the Court of Appeals also upheld the district court's decision not to award attorneys' fees or costs to either party.

Fourth Circuit Affirms Dismissal of Claims and Summary Judgment in Case Challenging Financial Services Company's Use of Proprietary Products in Its Retirement Plans

In *David v. Alphin*, 704 F.3d 327 (4th Cir. 2013), participants in a defined contribution plan and a defined benefit plan sponsored by a bank brought putative class claims under ERISA alleging breaches of fiduciary duty and prohibited transactions in connection with the selection of bank-affiliated mutual funds for the plans. Specifically, the plaintiffs alleged that the defendants breached their fiduciary duties of prudence and loyalty by selecting and failing to remove bank-affiliated funds from the plans despite poor performance and higher fees than other viable options. They further alleged that the defendants caused the plans to enter into transactions with the funds that were subject to conflicts of interest.

The U.S. District Court for the Western District of North Carolina dismissed all claims related to the defined benefit plan for lack of standing under Article III of the U.S. Constitution. After the completion of discovery, the district court granted summary judgment to the defendants as to all remaining counts on statute of limitations grounds.

The Fourth Circuit affirmed both rulings. With respect to claims concerning the defined benefit plan, the Fourth Circuit found that, under the plan, the plaintiffs were entitled to receive only a fixed level of retirement benefits. As a result, any risk to the plan's investments resulting from the defendants' investment selection had no effect on the participants' benefit rights, particularly where the plan was over-funded. Accordingly, the court held that the plaintiffs could not demonstrate actual harm sufficient to show an injury-in-fact as required for constitutional standing under Article III. The court rejected arguments advanced by the Department of Labor in an amicus brief in support of the plaintiffs, including the argument that the plaintiffs had representational standing to sue with respect to injuries to the plan even if they themselves had suffered no harm.

With respect to claims concerning the defined contribution plan, the Fourth Circuit held that the district court correctly concluded that the plaintiffs' claims were time-barred under ERISA's statute of limitations—which, in relevant part, bars actions commenced more than six years after the date of "the last action which constituted a part of the breach." Specifically, the court concluded that the alleged prohibited transactions and breaches of duty could be based only on the initial selection of the challenged funds for the plan. Where there was no dispute of fact that such initial selection occurred more than six years prior to the filing of the complaint, ERISA's six-year limitation period barred the claims. In this regard, the court rejected the plaintiffs' argument that the challenged conduct was not the initial selection of the funds, but the ongoing failure to remove the funds. The court held that the initial inclusion of bank-affiliated funds on the plan's investment lineup "triggered the limitations clock."

The Fourth Circuit also affirmed the district court's decision to dismiss the complaint with prejudice on the ground that the plaintiffs had not moved to amend the complaint and had already filed four complaints in the matter. The plaintiffs' petition for rehearing and/or rehearing *en banc* was subsequently denied.

Second Circuit Vacates Dismissal of Stock Drop Claim As to Plan That Neither Required Nor Encouraged Holding of Employer Stock

In two companion decisions, the Second Circuit Court of Appeals affirmed in part, and vacated and remanded in part, a decision by the United States District Court for the Southern District of New York dismissing all claims as to the inclusion in two 401(k)-style plans that allowed participants to invest in the stock of the sponsoring employer. *Taveras v. UBS AG,* 708 F.3d 436, No. 12-1662, 2013 WL 692720 (2d Cir. Feb. 27, 2013).

In *Taveras*, four former employees of a financial services company sued their former employer and related individuals and entities regarding investments in the employer's stock made by two company-sponsored retirement savings plans. The plaintiffs alleged that the stock investments were imprudent due, in part, to the sponsoring employer being on the "brink of collapse" as a result of alleged sub-prime exposure in 2007 and 2008. The plaintiffs purported to sue on behalf of a class of other participants and former participants of the two plans during a period when the price of the stock fell 74% between April 26, 2007 and October 16, 2008. The district court dismissed all claims, holding, among other things, that the plans' fiduciaries were entitled to a presumption of prudence under *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995), and that the complaint did not sufficiently plead the "dire circumstances" necessary to meet that standard. The Second Circuit Court of Appeals affirmed dismissal of the claim of breach of the duty of prudence as to one plan, the 401(k) Plus Plan ("Plus Plan"), but vacated and remanded as to the other, the Savings and Investment Plan (the "SIP").

As to the Plus Plan, the appellate court held that the presumption of prudence applied given that the plan document stated that one purpose of that plan was to provide employees the opportunity "to acquire" the company's stock, and elsewhere stated that one of the initial investment options for the Plus Plan "shall be" a fund consisting of the employer's stock — even though the plan also allowed the fiduciary committee to change options. Having found that the presumption of prudence applied given that plan language, the court in its companion order held that the presumption was not defeated by the pleaded allegations. The court acknowledged that it had not "defined precisely the contours of what constitutes a 'dire' situation sufficient to defeat the presumption of prudence," but it made clear that a "showing that the company made bad business decisions is insufficient to show that it was in a 'dire situation'" (internal quotations omitted). The court did say that any dire circumstances must be those that would have been "objectively unforeseeable" by the employer when it established the plan. It held that the pleadings at issue here did not meet that standard.

The Second Circuit, however, vacated dismissal of the prudence claim relating to the SIP and remanded for further proceedings. The SIP only mentioned the existence of an employer stock fund, and neither mandated such a fund nor strongly encouraged it. Under those circumstances, the court held that no presumption of prudence applies to the holding of employer stock because the policy underlying the *Moench* presumption, and the Second Circuit's earlier *Citigroup* decision (reported previously in the December 14, 2011 ERISA Litigation Update at the link available here), did not apply given that there was no need to balance a tension between a fiduciary's duty of prudence and an obligation under plan documents (encouraged by ERISA) to offer investment in employer stock.

As to both plans, the appellate court affirmed dismissal of other claims. The court held that statements in SEC filings (relating to corporate prospects effecting the company stock value) by the defendants were not actionable under ERISA because they were not made in an ERISA fiduciary capacity. Similarly, the court followed the settled principle that an "alleged ERISA fiduciary's mere officer or director status, taken alone, is insufficient to state a claim for conflict of interest" that would violate ERISA.

GOODWIN PROCTER ALERT

DECEMBER 13, 2012

District Court Refuses to Dismiss Challenge to Financial Services Company's Use of Proprietary Product for Its Own Retirement Plan

On November 20, 2012, the U.S. District Court for the District of Minnesota denied a motion to dismiss ERISA claims in a case challenging the use by a financial services company of affiliated investment products as options for its 401(k) plans. The case is Krueger v. Ameriprise Financial, Inc., No. 11-cv-02781, 2012 WL 5873825 (D. Minn. Nov. 20, 2012).

Krueger involves the 401(k) plan sponsored by a financial services company. The plan makes available as investment options proprietary mutual funds and collective trusts, along with a company stock fund and a brokerage window. Until last year, the brokerage window was managed by the sponsor. And until a 2007 sale, the plan's record-keeper was also an affiliate of the sponsor. The case was brought by seven current and former participants of the plan. Plaintiffs raised seven counts under ERISA, alleging breaches of fiduciary duty, prohibited transactions, co-fiduciary liability, and knowing participation in other's alleged breaches of duty. Plaintiffs asserted one claim alleging unjust enrichment under supposed federal common law.

Plaintiffs alleged that the investments managed by the sponsor or its affiliates were selected as options for the plan because they generated profits to the sponsor and its affiliates. Plaintiffs alleged that, as to some of those investment options, the sponsor used the plan's investments to "seed new and untested mutual funds," which had the alleged effect of making those funds more marketable outside of the plan. Among other things, the complaint also: (i) alleged the improper use of two tiers of fees in the proprietary target date funds made available on the menu, when supposedly comparable funds charged one tier of fees; (ii) challenged purported limitations on the funds available on the affiliated brokerage window — limitations which they allege were imposed because of "kickbacks" paid to the sponsor or its affiliates; and (iii) asserted that various fees charged in connection with the brokerage window and trust and recordkeeping services were improper.

The court followed the holdings in other "excessive fee" cases in its district — the Eighth Circuit Court of Appeals decision in *Braden v. Wal-Mart*, 588 F.3d 585 (8th Cir. 2009), and an earlier decision by the U.S. District Court for the District of Minnesota (*Gipson v. Wells Fargo*, 2009 WL 702004 (D. Minn. Mar. 13, 2009)) — to deny defendants' motion to dismiss. The court held that, like in those cases, plaintiffs' allegations plausibly alleged that the defendants selected affiliated funds "to benefit themselves at the expense of participants" and that the selection process was "flawed," each of which it found sufficient to support a claim of breach of ERISA fiduciary duty. The court also held that the fact that defendants included a range of investment options under the plan — which included investments managed by unaffiliated entities — did not shield defendants from liability. It further found that defendants could be liable for allegedly excessive record-keeping fees and for profits derived from the sale of its record-keeping and trust business if, as plaintiffs alleged, defendants used the plan's relationship to "prop up" the trust and record-keeping business for sale.

The *Krueger* court further held that (i) the plaintiffs' allegations sufficiently stated a claim for prohibited transactions given the affiliation between the plan sponsor and the fund managers; and (ii) exceptions to the prohibited transaction rules did not apply on a motion addressed to the pleadings as a procedural matter because such exceptions are of the nature of an affirmative defense. Largely on the basis of its rulings as to fiduciary breach and prohibited transactions, the court also allowed claims of failure to monitor and co-fiduciary liability to proceed. The only claim the court dismissed was a claim for common law unjust enrichment, which the court found to be preempted by ERISA.

Summary Judgment Decided in Suit Challenging Insurer's Use of Retained Asset Account to Settle Group Life Insurance Benefits

The U.S. District Court for the District of Massachusetts entered an order on cross summary judgment motions in one of the many cases challenging the use in group insurance benefit plans of retained asset accounts, denying the beneficiary's motion and granting, in part, the insurer's motion in Vander Luitgaren v. Sun Life Assurance Company of Canada, No. 09-11410, 2012 WL 5875526 (D. Mass. Nov. 19, 2012).

The litigation was brought by a beneficiary of a group life insurance plan whose sponsor had purchased group life insurance contracts from the insurer defendant. The insurer paid benefit claims under the group contract through interest-bearing accounts backed by funds that the insurer retained until the account holders wrote checks or drafts against the account. The plaintiff challenged the practice, which he claimed constituted a breach of fiduciary duty and a prohibited transaction under ERISA. The plaintiff purported to sue on behalf of a class of beneficiaries under contracts issued by the insurer defendant who had received their benefits through a retained asset account.

In 2011, the insurer's motion to dismiss the complaint was denied because, among other reasons, the court found that the plaintiff had adequately alleged that the insurer was an ERISA fiduciary with respect to retained assets.

In its recent order, the court granted summary judgment to the insurer on the plaintiff's prohibited transaction claim under ERISA § 406. The court found that nothing in the insurance contract suggested an ongoing property interest by the plan or participants in the insurer's assets that back retained asset accounts. Accordingly, the assets were not ERISA-governed plan assets. In this regard, the court distinguished the First Circuit's decision in *Mogel v. Unum*, 547 F.3d 23 (1st Cir. 2008), in which the appeals court held that sums due retained asset accountholders remained plan assets subject to ERISA fiduciary duties until "actual payment." The *Vander Luitgaren* court stated that *Mogel* should not be interpreted to hold that assets held in an insurer's general account – which are not plan assets – are "transformed into plan assets" once a defendant establishes a retained asset account. In rejecting the plaintiffs' fiduciary self-dealing claim, the court held that, unlike in *Mogel*, where the insurance contract required payment by lump sum, the contract at issue in *Vander Luitgaren* did not. The insurer therefore discharged any fiduciary obligations that it had with respect to the management and disposition of plan assets when it set up the account.

With respect to the plaintiff's claim for breach of fiduciary duties under ERISA § 404, the court denied the insurer's motion for summary judgment. The court followed the First Circuit's holding in *Mogel* that disposition of benefits to beneficiaries falls squarely within the insurer's fiduciary responsibilities with respect to plan administration, holding that the insurer was acting as a fiduciary with respect to plan administration when it paid the plaintiff's benefits claims. In particular, the court concluded that the insurer exercised discretionary fiduciary authority (i) in selecting to pay benefits via retained asset accounts; and (ii) in determining the crediting rates.

The court declined to decide the issue of whether the insurer breached its duty, noting that discovery was required to determine if the insurer was acting to optimize its own earnings when it established the retained asset accounts, and to determine if the interest rate that the insurer paid was competitive.

Third Circuit Holds Nonfiduciary Who Is Not a "Party in Interest" May Be Liable For Participation in Fiduciary's Violation of ERISA Section 406(b)(3)

In *National Security Systems, Inc. v. Iola*, No. 10-4154, 2012 WL 5440113 (3d Cir. Nov. 8, 2012), the U.S. Court of Appeals for the Third Circuit held that a nonfiduciary who knowingly participates in a fiduciary's breach of ERISA's anti-kickback provision,

Section 406(b)(3), may be subject to appropriate equitable relief under ERISA Section 502(a)(3), even though that nonfiduciary is not a "party in interest" under the statute's prohibited transaction rules.

The relevant facts of *National Security Systems* are as follows. Ronn Redfearn created a tax avoidance scheme (known as "EPIC") under which employers would establish ERISA-covered welfare plans and would make tax deductible contributions to a trust maintained for the plans. The trust in turn would pay premiums under life insurance policies selected by a company established by Redfearn to administer EPIC (the "Administrative Company"). The insurance policies would fund tax-free, annuity-like payments for the employer's owners after their retirement. The insurance company that issued the policies would pay commissions to the Administrative Company.

James Barrett, a financial planner, induced a number of his clients to become participating employers in EPIC, and Barrett became the contact person for their communications with, and contributions to, EPIC. The Administrative Company compensated Barrett for his services with payments from the commissions it received from the insurance company. After a number of years, the Internal Revenue Service audited the employers and determined that EPIC's structure did not satisfy applicable requirements under the Internal Revenue Code. The IRS disallowed the deductions the employers had taken for contributions to EPIC and assessed penalties against the employers. The employers then brought suit in federal district court in New Jersey against a number of entities and persons associated with EPIC, including Barrett, asserting violations of various laws, including ERISA.

As part of a decision resolving numerous claims and defenses (under ERISA and other laws), the district court ruled that Barrett had not acted as an ERISA fiduciary in connection with the plaintiff employers' participation in EPIC, but could be held liable for appropriate equitable relief as a nonfiduciary who had knowingly participated in the Administrative Company's violation of ERISA Section 406(b)(3), which prohibits a fiduciary from receiving consideration from a third party dealing with a plan in connection with a transaction involving plan assets. The district court concluded that the Administrative Company breached Section 406(b)(3) when it acted as a fiduciary in selecting the insurance policies in which contributions would be invested and received commissions from the insurance company issuing those policies. The court ruled that Barrett knowingly participated in this breach and ordered him to disgorge to the plaintiffs one half of the payments he had received from the Administrative Company. The court ordered this remedy under ERISA Section 502(a)(3), which authorizes appropriate equitable relief to remedy violations of the statute.

On appeal, Barrett argued that, under the leading case on nonfiduciary liability -- *Harris Trust and Savings Bank v. Salomon Smith Barney, Inc.*, 530 U.S. 238 (2000) -- only nonfiduciaries who are "parties in interest" under ERISA's prohibited transaction rules may be subject to liability for knowingly participating in a fiduciary's breach. Barrett noted that just last year, in *Renfro v. Unisys Corp.*, 671 F.3d 314 (3d Cir. 2011), the Third Circuit had indicated that *Harris Trust* had "authorized suits for nonfiduciary participation by parties in interest to transactions prohibited under ERISA." *Id*. at 325 n.6. He asserted that, because he was not a party in interest, he could not be subject to knowing participation liability under Section 502(a)(3).

The Third Circuit panel in *National Security Systems* rejected this argument and affirmed this aspect of the district court's decision. It reviewed the underlying analysis of the Supreme Court in *Harris Trust*, and concluded that, while the defendant in *Harris Trust* happened to be a party in interest, that fact was not critical to the Supreme Court's holding that nonfiduciary liability was authorized by Section 502(a)(3). The Third Circuit noted that the Supreme Court had emphasized that, in authorizing appropriate equitable relief to remedy violations of ERISA, the text of Section 502(a)(3) does not limit the persons who can be subject to liability. The panel in *National Security Systems* determined that the suggestion to the contrary by a different Third Circuit panel in *Renfro* was dicta — and, in any event, it was not bound to follow its own precedent that was inconsistent with the Supreme Court's reasoning in *Harris Trust*.

ICI MUTUAL **RISK MANAGEMENT STUDY**

ERISA Liability

A Guide for Investment Advisers and Their Affiliates

ICIMutual
A Risk Retention Group

ERISA Liability

Introduction

Investment advisers to mutual funds, and affiliates of advisers, play an important and highly visible role in the U.S. retirement system. Of $15.6 trillion in U.S. retirement assets as of September 2009, nearly $4 trillion was held in registered investment companies. Advisers to mutual funds also manage other investment vehicles that hold retirement assets, and fund advisers and their affiliates provide a broad array of services to retirement plans, plan sponsors and plan participants. In addition, advisers and their affiliates often sponsor and provide services for "in-house" retirement plans established for their own employees.

Advisers and their affiliates that operate in the retirement plan arena face specialized liability risks that derive in large part from the federal Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA imposes complex obligations and prohibitions on a broad array of entities and individuals associated with retirement plans and retirement assets, and the potential exposure created by ERISA for violating these obligations and prohibitions can be substantial.

These facts have not gone unnoticed by the plaintiffs' securities bar—i.e., that loose confederation of lawyers who specialize in pursuing large-scale recoveries on behalf of investors against financial institutions and other large corporations. The plaintiffs' bar has targeted fund advisers and their affiliates, among others, as defendants in recent ERISA-based litigation.

If litigation risks under ERISA are not always fully appreciated, the reasons are readily understandable. More than three decades after its enactment, ERISA remains an area of the law that defies easy comprehension. The intricacies of ERISA are not readily parsed, and the statute's requirements and prohibitions can prove challenging even to federal judges responsible for applying them in the context of civil litigation.[1]

Registered investment companies and fund independent directors are not subject to the obligations and prohibitions established by ERISA, or to the litigation exposures created by the statute. Accordingly, this guide is *not* directed towards the independent director community (although individual directors with an interest in the subject matter may find it a useful resource).

Rather, this guide is directed primarily towards senior management and legal and compliance personnel who seek a general introduction to ERISA and to ERISA-based litigation risks faced by fund advisers and their affiliates. The guide is intended to facilitate discussion between such personnel, on the one hand, and ERISA counsel and other ERISA specialists, on the other, and thereby to assist investment advisers and their affiliates in developing and implementing techniques and procedures for reducing and managing ERISA-based litigation risks.

Towards that end, this guide is structured as follows:

- **Part I** provides an overview of the retirement plan area, retirement plan services, and ERISA.
- **Part II** discusses public and private enforcement of ERISA, with a focus on large-scale civil litigation initiated by private (i.e., non-governmental) parties. Part II also analyzes four key areas of ERISA-based

litigation risk and how these risk areas may impact fund advisers and their affiliates.

- The **Appendix** lists selected ERISA-based lawsuits involving fund advisers and their affiliates—designed as a resource for readers wishing to review particular cases and/or to conduct additional research.

While this guide focuses on ERISA, it should be noted that state laws and/or contractual provisions may impose obligations and prohibitions identical or similar to those imposed by ERISA. Violations of such state laws and/or contractual provisions may therefore give rise to liability risks analogous to the ERISA liability risks discussed in this guide.

The observations in this guide are derived from ICI Mutual's interviews with investment management personnel, from consultations with ERISA counsel and other experts, and from ICI Mutual's examination of publicly available information on ERISA-based civil litigation and related issues.

As an introduction for the non-specialist, this guide necessarily generalizes as to the legal and operational issues discussed. It should not be construed or relied upon as legal advice (for which interested parties should look to their own counsel).

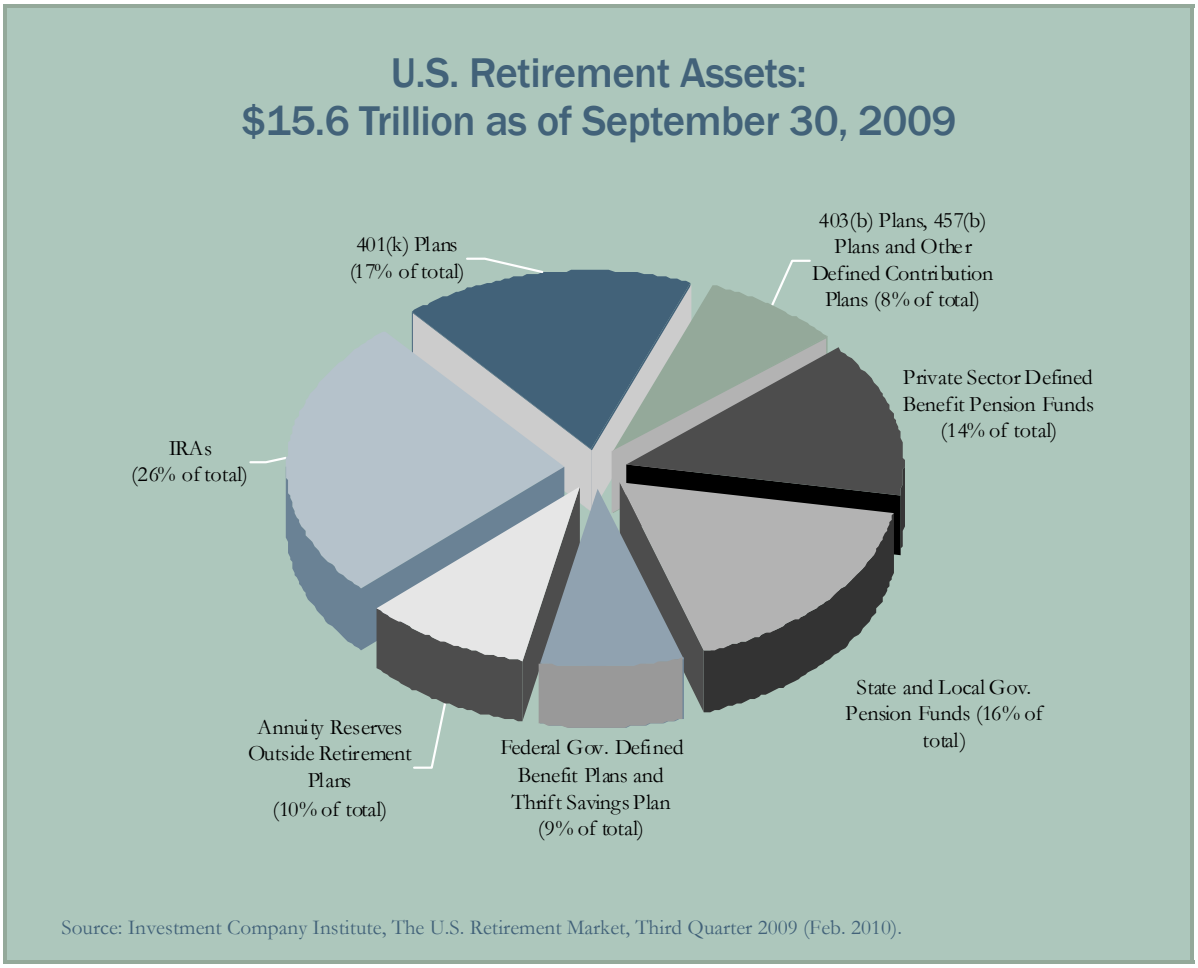
Part I: Fundamentals

Retirement Plans—In General

Since the enactment of ERISA in 1974, assets earmarked for the use of Americans in retirement have grown over forty-fold, totaling approximately $15.6 trillion (35% of all household financial assets) as of September 2009.[2] These retirement assets are held in various types of tax-advantaged arrangements commonly referred to as "retirement plans."[3]

TYPES OF RETIREMENT PLANS

There are numerous types (and sub-types) of retirement plans. Differences among them include: (1) the constituencies for which the plans are designed (e.g., the self-employed; employees and/or management of private sector, for-profit employers; employees of local, state or federal governmental entities; union members; or employees of tax-exempt entities); (2) the sources of contributions to the plans (e.g., individual plan participants; private sector, for-profit employers; government agencies or other public sector employers; labor unions; or tax-exempt entities); (3) the entities or individuals who bear responsibility for investment decisions and investment risks with respect to assets in the plans (see discussion of defined benefit and defined contribution plans on pages 6-7); and (4) the specific statutory, regulatory and tax requirements to which the plans are subject.



Defined Benefit and Defined Contribution Plans

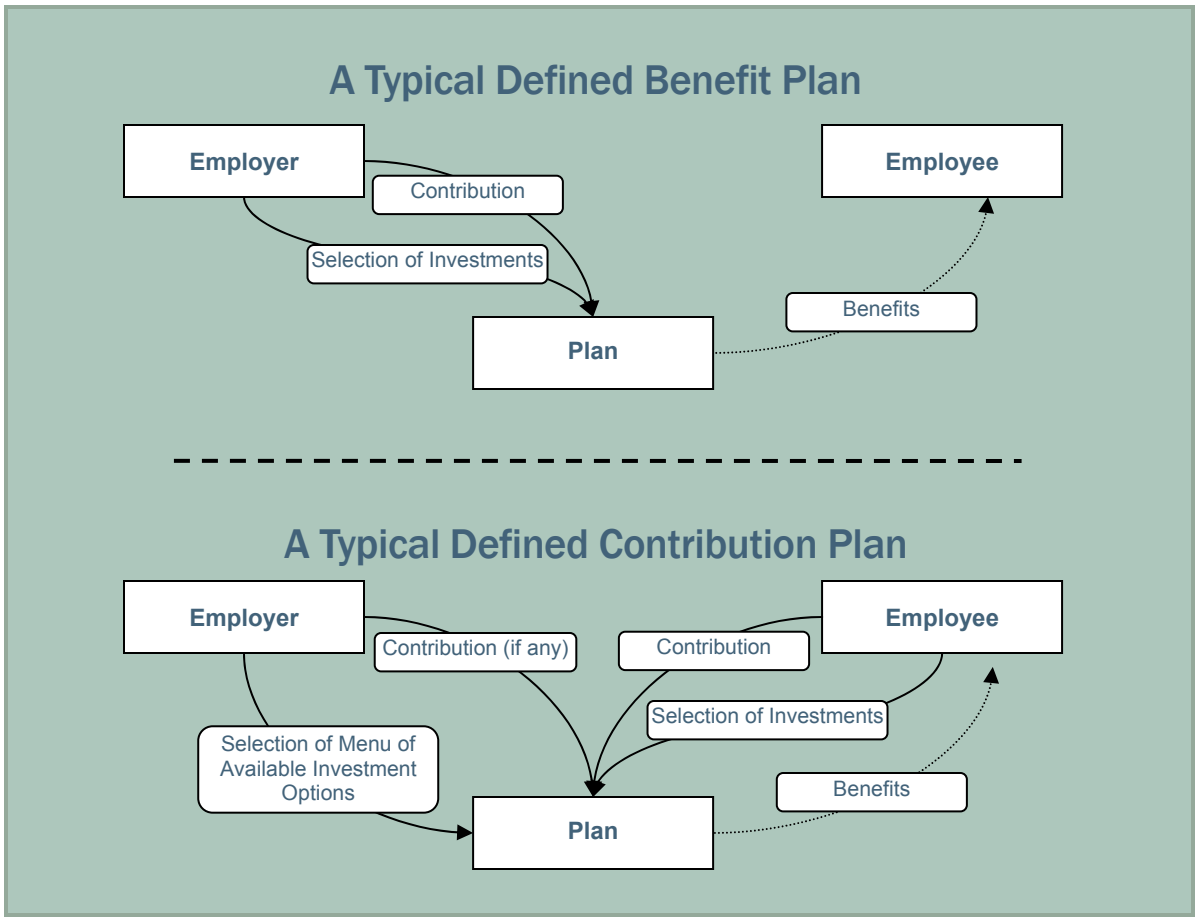
Regardless of their specific type, retirement plans can be placed into two broad categories:

Defined benefit plans entitle plan participants to fixed benefit amounts that become due to them upon their retirement. A participant's benefit amount is generally calculated under a preset formula that takes into account factors such as the participant's length of employment and salary. Responsibility for funding, contributing, and investing plan assets to meet the promised retirement benefit amount rests with the plan "sponsor" (typically, the participant's employer, or in the case of the public sector, a governmental entity), rather than with the individual participant.

The sponsor of a defined benefit plan typically bears both *investment risk* (i.e., the risk that the investment returns on the plan's assets will not be adequate to meet the fixed benefit amounts that will become due to the participant upon retirement) and *longevity risk* (i.e., the risk that the participant will outlive his or her expected lifespan, so as to require unanticipated additional benefits to be paid).[4] Employees in defined benefit plans do, however, bear the risk that the plan sponsor will freeze funding for a plan or terminate it.

So-called "employer pension plans" and the Federal Employees Retirement System ("FERS") are examples of defined benefit plans.

Defined contribution plans, by contrast, do not entitle plan participants to fixed benefit



amounts upon retirement. Rather, a participant's benefit amount upon retirement depends upon the contributions made over time by the participant (and/or his employer) and upon the investment returns that the participant achieves on these contributed assets. Responsibility for investing assets contributed on behalf of an individual participant commonly rests with the participant, rather than with the sponsor, although the sponsor typically selects a "menu" of investments from which plan participants may choose. Investment selections available to individual participants typically include professionally managed investment vehicles, including mutual funds; participants may also be permitted to invest in individual securities of their own selection or in the stock of their employers. The individual participant in a defined contribution plan typically bears both the *investment risk* and *longevity risk*.

401(k) plans and the federal government's Thrift Savings Plan ("TSP") are examples of defined contribution plans.

Over the decades since ERISA's enactment, there has been a shift away from defined benefit plans and towards defined contribution plans.[5] In 1974, defined benefit plans dominated the U.S. retirement landscape: approximately two-thirds of total retirement assets were then held in such plans, and defined contribution plans accounted for a minimal share.[6] Today, by contrast, defined contribution plans account for approximately 25% of retirement plan assets.[7] Individual retirement accounts ("IRAs")—which are closely analogous to defined contribution plans, in the sense that an IRA represents a tax-advantaged arrangement for retirement savings under which the individual typically remains responsible for investment selection and bears the investment and longevity risk—account for another 26%. Private-sector defined benefit plans account for only 14%. (The remaining retirement plan assets are distributed among state and local government plans, federal government plans, and annuities, as shown in the chart on page 5.)[8]

The increased share of retirement assets held in 401(k) plans, other defined contribution plans, and IRAs represents a shift in decision-making responsibility, investment risk, and longevity risk away from employers and towards individual participants.[9] With this shift has come growth and innovation in retirement products and services designed to assist these individual participants. As key providers of investment products and services, the fund industry has participated in this growth and innovation. The fund industry has also become a greater area of focus for the plaintiffs' bar, including those who specialize in ERISA actions.

401(k) Plans and IRAs

401(k) plans and IRAs are the two most common and best-known types of retirement plans.

401(k) plans—the "401(k)" being a reference to the relevant section of the Internal Revenue Code (the "Code")—are typically sponsored by private sector employers, and are often structured to permit employers to "match" all or part of their employees' own retirement contributions to the plan (or, in some cases, to permit employers to contribute to the plan a portion of the employers' own net profits).

401(k) plans are usually participant-directed, with plan participants themselves responsible for selecting individual investments from a menu of investment options made available to them.[10] These menus often include an array of mutual funds, with approximately $1.4 trillion (54%) of 401(k) plan assets held in mutual funds as of September 2009.[11]

Participants in 401(k) plans are also sometimes permitted to invest in individual securities, including securities made available through "brokerage windows." Historically, participants in many 401(k) plans have also been permitted to invest in their employer's stock, although the percentage of participants permitted to do so has declined substantially over the years.[12]

As discussed in this guide (see "Organization and Administration of ERISA Plans" on the next page), employers with 401(k) plans typically make arrangements with professional providers, including fund advisers and their affiliates, to provide various services to 401(k) plans and to plan participants.

IRAs are also participant-directed, and may be established for various reasons (e.g., to provide tax-advantaged retirement savings for employees without employer-sponsored plans; to supplement retirement savings in employer-sponsored plans; or to "roll over" assets in employer-sponsored plans upon changes in employment). Mutual funds are also a common investment choice for holders of IRAs. As of September 2009, over 46 million American households held approximately $4.1 trillion in IRAs, with approximately $1.9 trillion (46%) of IRA assets held in mutual funds.[13]

APPLICABILITY OF ERISA

Many—but by no means all—retirement plans are subject to the provisions and prohibitions of ERISA. Moreover, certain provisions and protections established by ERISA reach beyond assets held directly by such plans.

Retirement Plans Subject To ERISA

As a general rule, ERISA governs private sector retirement plans, but not public sector plans. Thus, for example, 401(k) plans, plans established by tax-exempt entities, and plans administered by union-management trustees are subject to ERISA; by contrast, the TSP, FERS, and state and local government retirement plans are not.

There are, however, exceptions to this general rule—as, for example, IRAs, which are not generally subject to ERISA, and so-called "403(b)" plans offered by public schools and certain tax-exempt organizations, some of which are subject to ERISA and some of which are not. The term "ERISA plan," as used in this guide, refers to a retirement plan whose assets are subject to the full provisions and proscriptions of that statute.

It is important to note that while state and local government plans typically are exempt from ERISA, there may be requirements and protections comparable to ERISA established by state law or state constitutions, and/or as a matter of contract.[14]

Types of Retirement Plans

	ERISA Plans	Non-ERISA Plans
Defined Contribution	• Private sector 401(k) plans • Some 403(b) plans • Others (e.g., employee stock ownership plans, profit-sharing plans, and some Keogh plans)	• Federal government Thrift Savings Plan • Some 403(b) plans • 457(b) plans • IRAs • Some Keogh plans
Defined Benefit	• Private sector defined benefit pension funds • Retirement plans administered by union-management trustee (Taft-Hartley plans) • Retirement plans established or maintained by tax-exempt entities	• Federal government defined benefit plans (e.g., the Civil Service Retirement System and Federal Employees Retirement System) • State and local government pension funds

Plan Assets Subject To ERISA

Investment vehicles that are not themselves ERISA plans may in certain circumstances be deemed to be holding "plan assets," such that their managers and service providers may find themselves subject to ERISA's fiduciary obligations and transaction prohibitions (discussed on pages 16-17). In order to assess whether a non-plan investment vehicle is itself holding "plan assets," ERISA "looks through" the assets of the non-plan investment vehicle to the underlying source of those assets.[15]

ERISA's look-through provisions are complex, but as a general rule, if more than 25% of a non-plan investment vehicle's assets are held by ERISA plans, the non-plan investment vehicle will itself be deemed to be holding "plan assets." There are important exceptions to this general rule, however, with two being of particular importance to fund advisers and their affiliates.

First, certain types of non-plan investment vehicles (e.g., bank common or collective trust funds and most insurance company separate accounts) do not enjoy the protection of the 25% test, such that these non-plan vehicles are deemed to hold "plan assets" if any of their assets are held by ERISA plans or certain other "benefit plan investors."[16]

Second, ERISA's look-through provisions do not apply to registered investment companies (such as mutual funds).[17] Thus, registered funds are generally not deemed to hold "plan assets" regardless of the number of fund shares owned by ERISA plans or plan participants.[18]

As a result, mutual fund advisers are not at risk of being subject to ERISA's fiduciary obligations and transaction prohibitions *solely* by virtue of their management of registered funds.[19] That being said, where fund advisers and/or affiliates also provide services to, and/or sponsor, ERISA plans (or other assets subject to ERISA), they may thereby be subject to ERISA's fiduciary obligations and transaction prohibitions, so as to be at risk for ERISA liability.

Organization and Administration of ERISA Plans

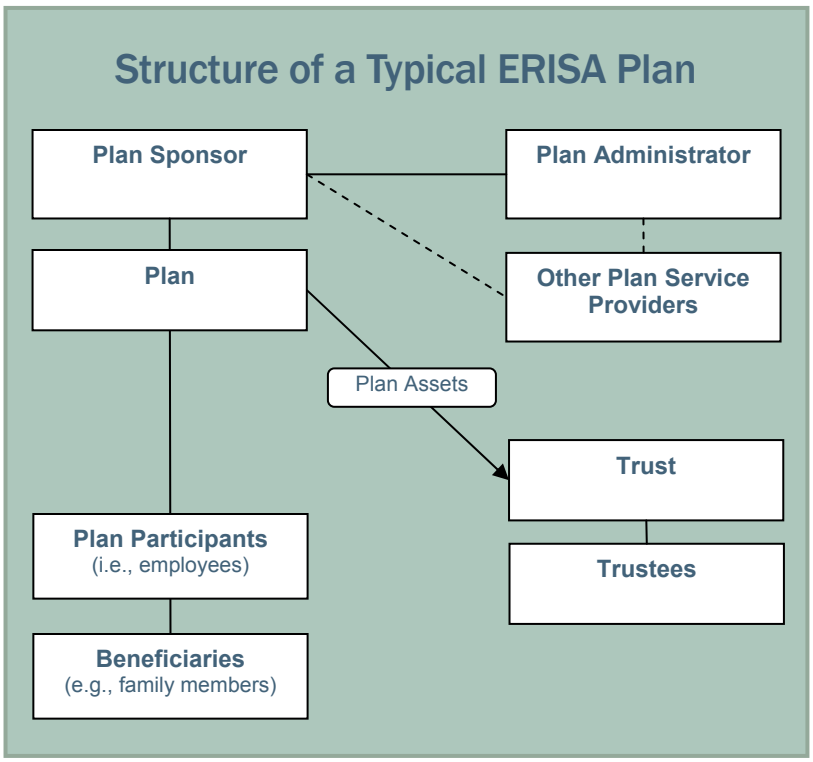
ERISA plans are programs designed to permit the tax-advantaged accumulation and distribution of retirement assets.

PLAN DOCUMENTS

The term "plan documents" commonly refers to two writings (which may be combined): the plan agreement (sometimes known as the plan instrument), and the trust instrument.

Plan Agreement: An employer typically "creates an ERISA plan with a written instrument called a 'plan agreement.'"[20] The plan agreement identifies the "named fiduciaries" who are authorized to control and manage the administration and operations of the plan. The plan agreement describes certain features that are mandated by ERISA or the Code (i.e., procedures for plan funding, plan amendments, and allocation of operational and administrative responsibilities, along with specifics on the basis for plan contributions and payments).[21] The plan agreement also generally includes certain features that are "optional" under ERISA (i.e., authorization for plan "fiduciaries" to serve in more than one fiduciary capacity, and authorization for named fiduciaries to employ consultants and appoint investment managers for plan assets).[22]

Trust Instrument: The trust instrument establishes the separate legal vehicle, or "trust," in which, as a general matter, assets of the plan must be held.[23] Either the trust instrument or the plan agreement generally identifies those parties who will be legally responsible for administration and oversight of the trust (e.g., the "trustees").



KEY PARTIES

A number of different parties are typically involved in the organization and administration of an ERISA plan. The roles and responsibilities of these parties are established (1) by ERISA itself, (2) by plan documents, (3) by contracts between and among the parties, (4) by custom and practice, and/or (5) by some combination of the foregoing.

Most commonly, these parties include:

Plan Sponsor: Under ERISA, each plan must have a "plan sponsor." The plan sponsor is usually the employer of the participants for whose benefit the plan is established. (However, the plan sponsor may sometimes be an employee organization or representatives of one or more employers and/or employee organizations.)

The plan sponsor is often a "named fiduciary" under the plan instrument,[24] although it may not always act in a "fiduciary" capacity for purposes of ERISA. For example, a plan sponsor typically acts in a non-fiduciary capacity (as a so-called "settlor") in making the original determination as to whether to establish a plan and an associated trust, and in making a number of decisions with respect to the plan's *non-investment* features (e.g., employee eligibility and vesting requirements, loan programs, and employer contributions). By contrast, a plan sponsor typically acts as a fiduciary in making decisions with respect to a plan's *investment* features (e.g., selecting the menu of investment options and making investment advice available to plan participants).[25]

The sponsor's functions are often performed by committees of individuals from the management of the sponsor. Such committees may take the form of "investment committees" (responsible for selecting investment options offered to participants) and "administration committees" (responsible for overall plan administration).[26]

Sponsors may employ consultants and appoint investment managers for plan assets. Plan sponsors also frequently contract with third

parties to provide various services to plans and plan participants.

For ease of reference in this guide, the term "plan sponsor" may variously refer, as the context requires, to the plan sponsor itself, or to the individual(s), committee(s), and/or the administrator that perform the plan sponsor's functions as a fiduciary.

Plan Administrator: Under ERISA, each plan must have a "plan administrator." The responsibility for plan administration defaults to the plan sponsor, unless another party is otherwise designated by the plan instrument.[27] In many cases, the plan sponsor (or a committee established by the plan sponsor) serves as the designated plan "administrator," but engages a third party to perform various types of day-to-day administrative services (a role sometimes referred to as a "third-party administrator").

Trustee(s): Most ERISA plans must hold plan assets in trust, and responsibility for administration and oversight of the trust rests with one or more trustees. ERISA provides that trustees have exclusive authority and discretion over the management and control of plan assets, unless (1) the authority has been delegated to an investment manager, or (2) the plan expressly provides that the trustee(s) will be subject to the direction of a named (non-trustee) fiduciary (in which case the trustee(s) is usually referred to as a "directed trustee").[28]

Investment Manager: Under ERISA, each plan may, but is not required to, have an "investment manager." An investment manager, if retained, serves as a plan fiduciary and has the "power to manage, acquire, or dispose of any asset of a plan."[29] ERISA permits an investment manager to be an investment adviser registered under the Investment Advisers Act of 1940, a state-registered investment adviser, a bank, or an insurance company.

Record Keeper (Defined Contribution Plans Only): 401(k) plans and other defined contribution plans commonly employ record keepers to track contributions, transactions, and expenses with respect to individual accounts of plan participants. A record keeper typically has other responsibilities as well, including monitoring various requirements affecting individual accounts (such as vesting requirements or loan eligibility requirements). Record keepers are often the primary point of contact for plan participants. Record keeping is often performed by third-party administrators or bundled service providers (discussed on the next page), but may in some cases be performed by the employer itself.

Actuary (Defined Benefit Plans Only): Fiduciaries to defined benefit plans typically retain actuaries to help ensure, among other things, that the plans are appropriately funded, given the expected value of future benefits.[30] In evaluating funding requirements, an actuary typically considers a range of economic assumptions (e.g., salary increases, interest rates, and inflation) and demographic assumptions (e.g., expectations with respect to the retirement age, longevity, and likelihood of disability of plan participants).

Custodian: A custodian typically provides services for settlement of securities transactions effected by the plan, safe-keeps plan assets, and may price plan assets. A custodian may also maintain records with respect to plan assets and transactions. If a plan has an institutional

trustee, that trustee typically provides custodial services.

Other Service Providers: Plans and plan fiduciaries also commonly engage various other service providers, including:

- *Consultants*, to provide advice to plan sponsors and plan fiduciaries with respect to certain of their responsibilities;
- *Lawyers*, to assist in compliance with ERISA and other applicable requirements and in contract review; and
- *Accountants*, to audit a plan's financial statements.

The extent to which plan services are outsourced by sponsors to third-party service providers varies, depending on the circumstances involved. Some sponsors (e.g., fund groups, banks, insurance companies, and large corporations) may have the capabilities and expertise to provide (either directly or through affiliates) an array of plan services to their own "in-house" plans, without extensive use of third-party providers. Other sponsors (e.g., smaller companies outside the financial institutions sector) may outsource many plan services, and may further rely heavily on consultants and lawyers to assist them in understanding and fulfilling their obligations under ERISA.

BUNDLED VS. UNBUNDLED ARRANGEMENTS

Sponsors may enter into so-called "bundled" or "unbundled" arrangements with third-party service providers.

Bundled Arrangements: In "bundled" arrangements, plan sponsors enter into agreements with single third-party service providers, who accept responsibility for providing the plans with a range of specified services (e.g., record keeping, custodial, and trustee services). The third-party service providers—sometimes referred to, in this context, as "platform providers"—may provide these various services either directly or through other service providers.[31] The third-party service providers' compensation arrangements with the plans and/or plan sponsors may reflect an aggregate fee for all of the bundled services provided.[32]

Unbundled Arrangements: In "unbundled" arrangements, by contrast, plan sponsors engage third-party service providers on a service-by-service basis. This typically necessitates that the sponsors arrange for separate contracts and separate compensation arrangements with the various service providers. Unbundled arrangements break out the cost of each individual service, as well as the role of each provider. But they may require greater expertise and experience on the part of the plan sponsors to seek out and enter into contracts with individual service providers, and may complicate sponsors' efforts to comply with their administrative responsibilities, including the responsibility to monitor the performance of the individual service providers.

ROLES AND RESPONSIBILITIES OF FUND ADVISERS AND THEIR AFFILIATES

Fund advisers and their affiliates that operate in the retirement plan arena have varying roles and responsibilities in the organization and administration of ERISA plans. The specific roles and responsibilities of a particular adviser/affiliate necessarily depend on various factors, including the adviser/affiliate's expertise, client base, and business model, as well as the nature of the plan.

In the context of ***third-party retirement plans*** (i.e., plans established for the benefit of employees of unaffiliated entities), and regardless of how their roles are formally labeled, the responsibilities commonly taken on by fund advisers and their affiliates can be broadly characterized as follows:[33]

Advisory Services: Fund advisers, of course, frequently manage mutual funds that are used as investment vehicles in retirement plans. In addition, fund advisers or their affiliates may manage other types of underlying vehicles (e.g., collective trust funds) that are available to plan participants as investment options. Fund advisers may also directly manage all or some portion of assets held by defined benefit plans or certain defined contribution plans.

Administrative Services: Affiliates of fund advisers may assist sponsors in establishing or terminating ERISA plans. Affiliates of fund advisers also regularly provide record-keeping services to ERISA plans, with some industry surveys of defined contribution plans finding a significant role for such affiliates in providing such services.[34] Affiliates of fund advisers also sometimes serve as trustees for ERISA plans, although in doing so, they typically seek to limit their role to that of a "directed trustee."

Regulatory/Compliance-Oriented Services: Affiliates of fund advisers sometimes serve as consultants to plan sponsors, assisting them in structuring and overseeing ERISA plans (e.g., assisting with the development of plan documents, the selection and monitoring of service providers, and the creation and monitoring of "menus" of investment options). Affiliates may also test plans for compliance with tax qualification requirements (e.g., "non-discrimination" testing), and may assist plan sponsors and administrators in complying with ERISA's reporting and disclosure obligations.

Participant-Focused Services: Affiliates of fund advisers may provide various services directly for participants in defined contribution plans. These services may include providing telephone or online assistance to plan participants (e.g., responding to inquiries regarding plan materials or plan services). Affiliates may also provide investor education, including generalized asset allocation advice, to plan participants,[35] and/or offer brokerage "windows" to permit participants to invest in individual securities.

In addition to providing the types of services described above to third-party retirement plans, fund advisers and their affiliates may also provide these services to ***in-house retirement plans*** (i.e., plans established for the benefit of their own employees). Fund advisers or their affiliates may also serve as sponsors and/or administrators of in-house plans.

* * *

As discussed in Part II of this guide, significant liability risks may attach to parties who are deemed to be acting as "fiduciaries" under ERISA in providing plan services. In some cases, the fiduciary status of a plan provider may be clear, whereas in others, that status may be open to debate and may be a key point of contention in civil litigation.[36] In such instances, resolution of the issue may require a fact-intensive analysis of the service provider's responsibilities both under ERISA and under relevant plan documents, and of the activities in which the provider is actually engaged.

ERISA—The Statutory and Regulatory Framework

After "more than a decade of investigations into the affairs of pension and employee benefit plans conducted by Congress, presidential commissions, and the Departments of Labor, Justice and Treasury,"[37] Congress enacted ERISA in 1974 in order "to promote the interests of employees and their beneficiaries in employee benefit plans."[38]

ERISA addresses two separate and distinct types of employee benefit plans. "***Employee pension plans***" provide retirement benefits or deferred compensation; "***employee welfare plans***" provide, among other things, medical, accident, sickness, death, and unemployment benefits. This guide focuses on retirement plans (i.e., employee pension plans that provide retirement benefits).

In designing ERISA, Congress intended to protect plan participants and beneficiaries against two types of risk that were of particular concern prior to the statute's enactment:[39]

Administration Risk is the risk that those charged with plan administration will fail to act honestly and prudently in investing and managing plan assets, and in paying benefits and claims. With respect to retirement plans, administration risk may be an issue for both defined benefit plans and defined contribution plans.

Default Risk is the risk that an employer, by reason of insolvency or otherwise, will default or otherwise fail to meet its obligation to pay benefits to plan participants and beneficiaries when the benefits become due. Default risk is more likely to be an issue for defined benefit plans, where decades may pass between the time a participant first earns the right to the future retirement benefits and the time that the benefits become payable by the employer.

Various ERISA requirements and provisions (such as those relating to funding, vesting, benefit accrual, and insurance) have substantially reduced default risk.[40] Administration risk, however, remains an issue and is hence the focus of this guide.

STATUTORY STRUCTURE

ERISA is, in the words of the U.S. Supreme Court, a "comprehensive and reticulated statute."[41] It comprises four major sections, or ***"titles."***

Title I contains detailed requirements relating to ERISA plans, including requirements on reporting and disclosure, and standards for participation, vesting, accrual of benefits, and funding of plans. Of particular significance to this guide, Title I includes stringent provisions relating to the conduct of "fiduciaries" and of other "parties in interest" to ERISA plans, and to civil and criminal enforcement of these and other provisions of ERISA.

Title II amends federal tax law (i.e., the Code) to mirror or complement various provisions of Title I, and sets forth tax incentives to encourage employers to maintain—and employees to participate in—employee benefit plans that meet certain requirements.[42] These requirements relate to limits on plan contributions and benefits, nondiscrimination provisions for plan participation, and rules for distribution of plan assets (e.g., plan loans, early withdrawals, and rollovers).

Title III addresses jurisdictional issues among the federal agencies charged with oversight and enforcement of ERISA, and promotes coordination among them. (These agencies, and their general responsibilities, are discussed on the next page).

Title IV establishes federal insurance arrangements guaranteeing benefits for participants in private-sector defined benefit (i.e., pension) plans.[43] Title IV also established the Pension Benefit Guaranty Corporation ("PBGC"), the independent government agency providing such guarantees.

GOVERNMENT OVERSIGHT

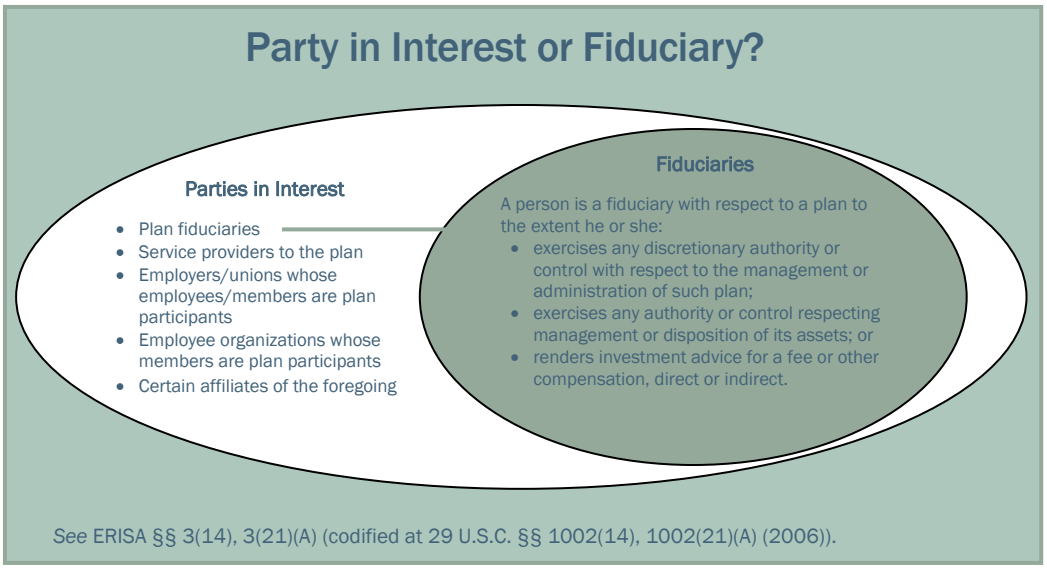
Several different government agencies are responsible for administration and regulatory enforcement of ERISA. The ***U.S. Department of Labor*** ("DOL") and the ***Employee Benefits Security Administration*** ("EBSA"), a separate office in the DOL, have primary responsibility for administering and enforcing the provisions of Title I, and for conducting civil and criminal investigations of potential ERISA violations. (As discussed at page 21, ERISA also authorizes certain private parties—including plan participants—to bring civil lawsuits to enforce ERISA provisions.)

The ***U.S. Department of the Treasury*** ("Treasury Department") and the ***Internal Revenue Service*** ("IRS"), a separate agency within the Treasury Department, have primary responsibility for administering the tax and qualification provisions of Title II. They also oversee and enforce compliance with Code requirements relating to participation, vesting, and funding standards applicable to ERISA plans. As noted above, the PBGC administers the insurance arrangements established under Title IV.

FOCUS ON FIDUCIARIES AND OTHER PARTIES IN INTEREST

ERISA addresses administration risk by providing for detailed oversight and regulation of entities and individuals who are associated with the investment of retirement plan assets, the administration of plan affairs, and the provision of services to plan participants and beneficiaries.[44]

These entities and individuals, as well as certain of their affiliates, constitute ***"parties in interest,"*** a term broadly defined in ERISA.[45] Some, but not all, parties in interest also qualify as ERISA ***"fiduciaries,"*** a term that is likewise broadly defined in the statute.[46]



The U.S. Supreme Court has held that ERISA "abounds with the language and terminology of trust law." Indeed, the legislative history of ERISA "confirms that the Act's fiduciary responsibility provisions are designed to 'codif[y] and mak[e] applicable to' ERISA fiduciaries certain basic principles derived from that body of common law."[47] It is not surprising, then, that judicial

treatment of fiduciaries under ERISA draws heavily from the treatment of trustees under common law.[48]

More specifically, ERISA subjects fiduciaries to heightened scrutiny, more rigorous responsibilities, more stringent prohibitions, and increased liability relative to other parties in interest.[49] Presumably, this is because fiduciaries—by virtue of their access to, and ability to manage and/or control, plan assets—can more readily act to the detriment of plan participants and beneficiaries than can other parties in interest.

As noted above, a plan agreement must identify the plan's "named fiduciaries." But as the courts have recognized, named fiduciaries "are not … the only individuals who are considered fiduciaries under ERISA."[50] ERISA defines a "fiduciary" largely by reference to whether an entity or individual *possesses or exercises authority or control* with regard to plan assets, management, or administration, or *provides investment advice for a fee*, rather than by reference to the specific *position* held by such entity or individual.[51] Indeed, a party may be deemed a "fiduciary" with respect to certain of its activities, but not others.[52]

This definitional approach leaves little or no doubt as to the fiduciary status of certain entities and individuals (e.g., investment advisers to defined benefit plans), but has created debate as to the circumstances, if any, under which certain other entities and individuals (e.g., consultants) should be so viewed. Fiduciary status is often a key threshold issue in civil litigation under ERISA.

Fiduciary Responsibilities

ERISA holds fiduciaries to high standards of conduct, and requires them to discharge their duties "solely in the interest of the [plan's] participants and beneficiaries."[53] Broadly speaking, ERISA requires fiduciaries:

(1) to act for the exclusive benefit of plan participants and beneficiaries;

(2) to exercise the care and diligence of a "prudent expert";

(3) to ensure appropriate diversification of plan investments; and

(4) to comply with governing plan documents (to the extent such documents are consistent with the provisions of ERISA).[54]

As discussed in Part II, a fiduciary that violates these obligations is at risk for regulatory and civil liability, including personal liability for plan losses and restoration of any profits made by the fiduciary through misuse of plan assets. Non-fiduciary "parties in interest" associated with such violations may also find themselves at risk.[55]

Prohibited Transactions

Separate and apart from the affirmative responsibilities assigned to fiduciaries, ERISA also places express prohibitions on fiduciaries with regard to plans and plan assets. These "prohibited transactions" can be divided into two categories:

Prohibited Transactions Between Plans and Fiduciaries: ERISA imposes prohibitions on fiduciaries in the areas of self-dealing, conflicts of interest, and "kickbacks."[56] Broadly speaking, ERISA prohibits a fiduciary from:

(1) dealing with plan assets in its own interest or for its own account;

(2) acting in any transaction involving the plan on behalf of a party whose interests are adverse to those of the plan or of its participants or beneficiaries; and

(3) receiving any consideration for its own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

Prohibited Transactions Between Plans and Parties in Interest: ERISA broadly prohibits fiduciaries from causing a plan to engage, whether directly or indirectly, in the following types of transactions involving parties in interest:[57]

(1) sales, exchanges, or leases of property between a plan and a party in interest;

(2) lending of money or other extensions of credit between a plan and a party in interest;

(3) furnishing of goods, services, or facilities between a plan and a party in interest;

(4) transfers of any plan assets to, or use of any plan assets by or for the benefit of, a party in interest; and

(5) acquisition and retention by a plan of employer securities or employer real property in violation of ERISA.

Note that the prohibitions in this second category—i.e., prohibitions on "party in interest transactions"—apply, by their terms, to *fiduciaries*, rather than to all parties in interest. Thus, potential liability for violation of party in interest transactions lies, in the first instance, with ERISA fiduciaries themselves. Nonetheless, *parties in interest* who are not otherwise ERISA fiduciaries are not themselves immune from risk. Non-fiduciary parties in interest may be liable for excise taxes on the amounts involved in prohibited transactions, and may be required in litigation to disgorge fees received in connection with prohibited transactions.[58]

Statutory and Administrative Relief

ERISA's provisions are so broad as to severely limit the ability of fiduciaries and parties in interest to provide otherwise necessary and appropriate services to retirement plans, absent a statutory exemption or other relief.

Statutory Exemptions: In recognition of this fact, ERISA itself contains statutory exemptions from the prohibited transaction provisions. Of particular relevance to fund advisers and their affiliates are statutory exemptions that permit:

(1) fiduciaries and other parties in interest to provide legal, accounting, and other services "necessary for the establishment and operation" of an ERISA plan, subject to certain conditions (and to a DOL regulation that leaves this exemption inapplicable to the prohibited transactions between plans and fiduciaries described above);[59]

(2) fiduciaries and other parties in interest to engage in "blind" securities transactions with ERISA plans on securities exchanges (and, in certain situations, through alternative trading systems, electronic communications networks, and similar execution systems or trading venues);[60] and

(3) non-fiduciary parties in interest to engage in certain transactions (including sales, exchanges or leasing of property, loans or other extensions of credit, and certain transfers or uses of plan assets) with ERISA plans, subject to certain conditions."[61]

Administrative Exemptions: In addition to statutory exemptions, ERISA authorizes the DOL to grant administrative exemptions to the prohibited transaction provisions. Administrative exemptions typically take the form of either "individual" exemptions or "class" exemptions.

Individual exemptions address *specific transactions* for which affected participants are seeking individualized relief, and may not be relied on by other parties. ***Class exemptions***, by contrast, tend to focus on particular *types* of transactions or entities, and may generally be relied on by any parties meeting the conditions of the relevant exemptions.

Of particular relevance to fund advisers and their affiliates are class exemptions that permit:

(1) a plan fiduciary of a third-party plan to invest assets in a mutual fund managed by that same

fiduciary or its affiliates, subject to certain conditions;[62] and

(2) a plan fiduciary of an in-house plan to invest assets in a mutual fund managed by that same fiduciary or its affiliates, subject to certain conditions.[63]

Two other class exemptions—the so-called QPAM and INHAM exemptions—have also traditionally been important to the fund industry. These two class exemptions permit "investment funds" (e.g., insurance company separate accounts or bank common or collective trust funds) managed by QPAMs[64] or INHAMs[65] (i.e., "qualified professional asset managers" or "in-house asset managers," respectively) to engage in otherwise prohibited transactions with parties in interest, subject to certain conditions.[66]

DOL Guidance: The DOL also issues ***advisory opinions*** (which apply ERISA to a specific set of facts), ***information letters*** (which call attention to ERISA interpretations or principles without applying them to specific factual situations), ***field assistance bulletins*** (which, as part of the DOL's compliance assistance program, are designed, among other things, to assist employers, service providers, and others in complying with particular ERISA provisions), and ***interpretive bulletins*** (which set forth the DOL's views on particular topics).[67]

Thus, for example, in a series of advisory opinions, the DOL has interpreted the prohibited transaction provisions of ERISA to permit certain service providers to receive fees from mutual funds available as investment options in the plan, subject to certain conditions.[68]

* * *

The issue of whether a fiduciary has breached its obligations under ERISA is frequently contested in civil litigation and can be a fact-intensive inquiry. The inquiry may often require a detailed understanding of relevant decisions, interpretations, and guidance that have been provided by governmental agencies (i.e., the DOL, and, in some cases, the IRS) and the courts.

Part II: ERISA Litigation

ERISA Enforcement—In General

ERISA's "comprehensive civil enforcement scheme"[69] provides for "a panoply of remedial devices."[70] The remedies and sanctions established under ERISA largely supersede (rather than supplement) fiduciary-based exposures to which plan sponsors and plan service providers might otherwise be subject under state law or federal common (i.e., court-created) law.[71]

ERISA's remedies and sanctions are themselves robust. Plan sponsors and plan service providers can be at substantial financial risk where loss or diminution of retirement assets can be traced to their actual or alleged failure to adhere to the broad responsibilities and prohibitions placed on them by the statute.

PUBLIC AND PRIVATE ENFORCEMENT OF ERISA

The DOL spearheads ***public enforcement*** of ERISA. The statute provides the department with broad enforcement authority, and each year the DOL—acting on its own or along with other governmental authorities (e.g., the IRS, U.S. attorneys' offices, the SEC)—pursues several thousand investigations into potential civil (and in some cases, criminal) violations.

Most of these DOL investigations are ultimately closed "with results"—i.e., with monetary recoveries obtained for plans and/or with other corrective action being taken.[72] Although the DOL often is able to achieve its results through voluntary compliance by plan sponsors and fiduciaries, civil litigation is initiated in a relatively small number of cases.

These DOL investigations include proceedings to correct violations of ERISA's prohibited transaction provisions. Such proceedings are commonly resolved through unwinding the offending transaction and/or a payment by the responsible entity or individual (i.e., the party in interest and/or the ERISA fiduciary).

ERISA also permits ***private enforcement*** (i.e., non-governmental enforcement) of its provisions. Specifically, the statute authorizes plan participants, plan beneficiaries and ERISA fiduciaries to initiate litigation in federal courts for breaches of duty by ERISA fiduciaries, along with other violations of ERISA and of the terms of ERISA plans.

Since 2000—and in the aftermath of WorldCom, Enron, and other events that have had dramatic impacts on values of employer stock and other plan investment options—ERISA has generated a significant amount of private civil litigation. By one estimate, over 2,400 ERISA-based lawsuits were filed during the period 2005-08 alone.[73] Such lawsuits can involve significant financial exposure for the defendants involved, with settlements in the eight figures (or higher) not uncommon.[74]

TYPES OF PRIVATE CIVIL LITIGATION UNDER ERISA

Broadly stated, there are two types of private civil litigation under ERISA: (1) participant benefits and rights litigation and (2) fiduciary litigation.

Each type of litigation presents risks for those who may be named as defendants. From the perspective of fund advisers and affiliates, however, the more serious type of civil litigation under ERISA is fiduciary litigation, which, as discussed below, generally involves greater potential exposure. This guide focuses on fiduciary litigation.

Participant Benefits and Rights Litigation

In this type of litigation, participants generally seek to recover benefits due to them, or to enforce their rights, under the terms of their plans. For example, plaintiffs may charge that (1) their retirement benefits have been improperly calculated based on erroneous information regarding their years of service or final salaries; or (2) defendants have failed to effect requested transactions for their participant accounts.

Lawsuits of this type are typically brought by plan participants (or beneficiaries) against plan administrators or, in certain cases, other plan providers.[75]

Fiduciary Litigation

In this type of litigation, defendants, in their purported roles as plan "fiduciaries," are charged with failing to meet one or more of the various fiduciary obligations placed upon them by ERISA.

Fiduciary lawsuits are typically brought (1) on behalf of plan participants against plan sponsors, administrators, trustees, and/or plan service providers; or (2) by plan sponsors, administrators or trustees against "outside" investment managers or other plan service providers.

Fiduciary litigation typically seeks monetary relief (in the form of "make whole" damages) from defendants, and can itself be subdivided into two categories:

Challenges to Management of Plan Assets: Here, plan sponsors, administrators, investment managers, and/or other plan service providers are charged with failing to meet their fiduciary obligations with regard to the investment of plan assets and/or the offering of plan investment options. Examples include (1) so-called "stock drop" lawsuits, in which plan participants allege, following a decline in the price of an employer's stock, that plan fiduciaries knew or should have known that employer stock was an imprudent investment option,[76] and (2) recent "credit crisis" lawsuits, in which providers of investment management services to funds offered as investments in ERISA plans have been charged with failure to act prudently when investing plan assets in various types of securities.[77]

Challenges to Plan Administration: Here, plan sponsors, administrators, investment managers, and/or other plan service providers are charged with failing to meet their fiduciary obligations with regard to plan administration. Examples include recent "revenue sharing" lawsuits (described on pages 29-30), in which plan sponsors, trustees, and/or other service providers have been charged with violating their obligation to act for the exclusive benefit of plans and plan participants by making available investment options with "excessive and unreasonable" fees and costs.[78]

ROLE OF THE PLAINTIFFS' BAR

Fiduciary litigation under ERISA is often brought by *plan participants* (and/or beneficiaries), acting either as representatives of a "class" of like-situated individuals or on behalf of the plan as a whole. As in the case of shareholder class action lawsuits brought under the federal securities laws against issuers (including mutual funds), counsel to participants and beneficiaries in fiduciary litigation under ERISA tend to be associated with the plaintiffs' bar.

As a practical matter, in these lawsuits, it is often plaintiffs' counsel, and not the affected participants or beneficiaries, who initiate and control the litigation. (For a description of today's plaintiffs' bar and its role in federal securities class action litigation, see ICI Mutual's publication *Mutual Fund Prospectus Liability: Understanding and Managing the Risk* (2010).)

The complexity and uncertainty of ERISA can themselves be "a potent weapon" for plaintiffs in fiduciary litigation.[79] There are also other specific reasons—including procedural differences between ERISA litigation and litigation under the federal securities laws—that explain ERISA's appeal to the plaintiffs' bar.[80]

Indeed, over the past decade, the plaintiffs' bar has played an instrumental role in the emergence of "a new ERISA litigation industry."[81] These lawyers have been initiating fiduciary lawsuits under ERISA as stand-alone litigation, or, as has become common in recent years, as "companion" litigation to shareholder class action lawsuits brought under the federal securities laws.[82]

This trend by the plaintiffs' bar towards pursuing parallel litigation attacks against issuers and associated "deep pocket" defendants—i.e., attacks under both the federal securities laws and under ERISA—has affected not only operating companies, but the fund industry as well. Thus, for example, in the aftermath of market timing regulatory actions in 2003 and 2004, more than twenty fund groups became the targets of large numbers of civil lawsuits. Many of these fund groups were required to defend not only against class action and derivative lawsuits brought on behalf of fund shareholders under the federal securities laws and/or common law, but also against "companion" lawsuits under ERISA brought on behalf of participants in the in-house 401(k) plans offered by the advisers, the advisers' parent companies, and/or their affiliates.[83]

INSTITUTIONAL PLAINTIFFS

Fiduciary litigation under ERISA is also initiated by *plan fiduciaries*—typically, plan sponsors, plan administrators, and/or plan trustees. These plan fiduciaries are usually institutions (or individuals associated with institutions), and tend to be "sophisticated litigants."[84] Although these institutional plaintiffs sometimes utilize counsel from the plaintiffs' bar, or otherwise adopt strategies and techniques used by the plaintiffs' bar, [85] they nevertheless often retain substantial control over the litigation effort.

As one observer has noted, these institutional plaintiffs "are conservative business litigants using plaintiffs' tools seeking to recoup significant losses." As institutional plaintiffs, they "may be unlikely to accept quick compromises, and, mindful of their own fiduciary obligations, may well be unwilling to accept any compromise that does not represent a very significant percentage of the losses."[86]

Why Fiduciary Litigation Sometimes Settles

Because of the fact-intensive nature of various of the issues in fiduciary litigation (see generally pages 24-27), the issues may be difficult to resolve in a defendant's favor on a motion to dismiss or otherwise at a pre-trial stage of the litigation process. As a practical matter, this increases the risk of "deep pocket" plan service providers being named as defendants in fiduciary litigation, particularly in cases involving employer collapses or similar catastrophic events.

If a lawsuit survives a defendant's pre-trial challenges, the prospect of protracted litigation can provide a defendant plan service provider with a disincentive to proceed to a trial on the merits, and a negotiated settlement of the litigation may result. The relative strength or weakness of the evidence marshaled by plaintiffs and defendants on various relevant issues, as well as the risk (however remote) of substantial potential liability, may factor into their assessments of the overall settlement value of the lawsuit.

Contested Issues in Fiduciary Litigation

While it may seem self-evident, it is nevertheless important to appreciate that a fiduciary lawsuit under ERISA "is not a securities suit." Rather, it is "an action against fiduciaries of a pension plan" that is governed under ERISA's independent legal framework.[87]

In order to establish liability on the part of defendants in such a lawsuit, plaintiffs generally must demonstrate that (1) the plaintiffs have a legal right (i.e., "standing") to pursue the litigation, (2) the defendants are plan "fiduciaries," and (3) the defendants violated (i.e., "breached") their fiduciary duties under ERISA, causing harm to the plaintiffs.[88]

Defendants frequently contest some or all of these issues. Federal court decisions on these issues have, in turn, generated considerable debate and commentary, reflecting the complexities that can arise when courts must resolve these basic issues in the context of litigation. Although a detailed discussion is outside the scope of this guide, this section is designed to provide an introduction to these issues, and to provide some observations regarding the nature of the debate and commentary around them.

STANDING

Among the stated purposes of Congress in enacting ERISA was to provide "for appropriate remedies, sanctions, and ready access to the Federal courts."[89] Yet ERISA does not provide would-be litigants with unlimited access. Rather, ERISA's own text, through "carefully integrated civil enforcement provisions,"[90] dictates who has the legal right to bring lawsuits under the statute (i.e., standing), and on what basis.[91]

Plaintiffs who pursue fiduciary lawsuits under ERISA typically claim authority to do so under:

(1) **Section 502(a)(2)**, which authorizes participants, beneficiaries, and fiduciaries to pursue private (i.e., non-governmental) lawsuits to *enforce* section 409 of ERISA (which, in turn, *creates* personal liability for fiduciaries who breach their fiduciary duties),[92] and/or

(2) **Section 502(a)(3)**, a "catchall" provision which authorizes participants, beneficiaries, and fiduciaries to pursue lawsuits for violations of "any" provision of ERISA or of the terms of individual ERISA plans.[93]

Historically, section 502(a)(2) has been interpreted by the courts to permit plaintiffs to obtain ***monetary relief*** (i.e., "make whole" damages), but only where the defendant's breach of its fiduciary obligations causes harm to *the plan itself*.

Meanwhile, section 502(a)(3) has for some years been interpreted to permit plaintiffs to seek relief for *individualized* harm caused by a defendant's breach of its fiduciary obligations. But plaintiffs proceeding under section 502(a)(3) may secure only appropriate ***equitable relief*** (i.e., relief that is typically non-monetary, such as reinstatement of benefits, etc.).

These two provisions date back to ERISA's enactment in an era of *defined benefit plans*, and courts in recent decades have wrestled with how, if at all, these provisions limit the rights of participants in *defined contribution plans* to pursue lawsuits under ERISA. In 2008, the U.S. Supreme Court resolved certain remaining disagreements among the lower courts on this issue.[94] The Court held that participants in 401(k) and other defined contribution plans have the legal right to sue plan fiduciaries for monetary relief under section 502(a)(2). The Court reaffirmed that section 502(a)(2) requires harm "to a plan" itself, but reasoned that harm to an individual

participant account is sufficient to establish harm to the plan.[95]

The Supreme Court has thus clarified that individual plan participants have standing to pursue "make whole" monetary recoveries in fiduciary litigation under ERISA. The Court's decision has thereby underscored the potential financial exposure faced by sponsors and plan service providers—including fund advisers and their affiliates—in the current litigation environment. Indeed, a federal appellate court relied heavily on the Court's decision in concluding that former employees who had cashed out of in-house 401(k) plans sponsored by fund groups had standing to pursue market timing-related ERISA fiduciary litigation against various fiduciaries of the plans.[96]

Notwithstanding the recent Supreme Court decision, certain other legal questions remain unresolved under section 502(a)(2), such as the extent to which participants can pursue their lawsuits as class actions.[97] These unresolved questions have significant potential implications for ERISA fiduciaries involved in litigation brought by participants in 401(k) (and other defined benefit) plans.

There also remain unresolved legal questions with regard to section 502(a)(3)—including whether, and under what circumstances, private litigants may sue for *monetary* relief.[98] This issue, too, has implications for litigation (although these implications may be of lesser practical importance, at least in the defined contribution plan arena).

FIDUCIARY STATUS

As discussed above, section 409 of ERISA creates personal liability for those who qualify as "fiduciaries" under the statute. More specifically, section 409 provides that fiduciaries who breach "any of the responsibilities, obligations, or duties imposed upon fiduciaries" by ERISA shall be personally liable "to make good" any losses to a plan resulting from their breach, and to restore any profits made by the fiduciaries through their use of plan assets. In order for a plaintiff to *enforce* section 409 in fiduciary litigation, the plaintiff must typically establish that the defendant is, in fact, a "fiduciary," as that term is defined in ERISA.[99]

Other Sources of Potential Liability

Under certain circumstances, plan service providers may be at risk of civil liability (1) for the fiduciary breaches of others and/or (2) for knowingly participating, even as a non-fiduciary, in an unlawful act:

- ***Co-Fiduciary Liability:*** A plan service provider that is itself deemed to be acting as a fiduciary may be liable for fiduciary breaches by *other* plan fiduciaries (so-called "co-fiduciary" liability) under section 405(a) of ERISA.[100] Such co-fiduciary liability may attach if (1) a fiduciary knowingly participates in or conceals a breach of another fiduciary; (2) the fiduciary's failure to comply with its own fiduciary obligations enables another fiduciary to commit a breach; or (3) the fiduciary knows of a breach by another fiduciary, but does not make reasonable efforts to remedy the breach.[101]
- ***Liability of Non-Fiduciaries:*** A plan provider that is *not* itself a fiduciary may nevertheless be liable if it knowingly (in either an actual or constructive sense) participates in an action prohibited under ERISA.[102] As a practical matter, in fiduciary litigation naming a plan service provider among the defendants, a claim that the provider breached its fiduciary duties is likely to be coupled with an alternative claim alleging that the provider, even if not a fiduciary, was a knowing participant in an act unlawful under ERISA.

As discussed on page 16, plan fiduciaries may encompass both "named" fiduciaries and "functional" fiduciaries.[103] There may be little or no doubt, in some cases, as to the fiduciary status of particular defendants. In other cases, however, the issue may be less clear. For example, certain types of "administrative" and "consulting" activities have generated disputes over fiduciary status in recent

litigation. Indeed, in the words of one observer, "the federal district courts continue to grapple with the issue" of when a "defendant service provider qualifies as an ERISA fiduciary."[104]

In making determinations of fiduciary status, courts often focus heavily on the particular facts involved—e.g., the wording of the particular plan document(s) at issue, the nature of the directions received by the defendant (by contract or otherwise), and/or the defendant's actual activities.

PLAN LOSSES RESULTING FROM BREACH OF FIDUCIARY DUTY

If plaintiffs have standing to pursue their lawsuit, and if a defendant is deemed to be acting as an ERISA fiduciary, plaintiffs seeking "make whole" monetary relief in fiduciary litigation must further demonstrate that the defendant fiduciary is *liable*.

Fiduciary liability under ERISA is created primarily by section 409 of the statute. Although section 409 does not "contain the exclusive set of remedies for every kind of fiduciary breach,"[105] fiduciary litigation of greatest concern to fund advisers and affiliates generally requires satisfaction of the section. The section sets forth three criteria that must be met in order for liability to attach: (1) breach of fiduciary duty, (2) losses to the plan and/or ill-gotten profits to the fiduciary, and (3) causation.[106]

Breach of Fiduciary Duty

Section 409 provides that a defendant fiduciary must violate (or "breach") one or more of "the responsibilities, obligations, or duties" (collectively, "duties") that are imposed upon fiduciaries by ERISA. Assuming that a duty does clearly exist (and this may be a contested issue[107]), whether defendants have in fact violated that duty is an issue that is typically disputed by the parties.

Given the broad and generalized nature of these duties (as discussed in Part I), it is rarely difficult for plaintiffs in fiduciary litigation to *allege* that defendants have violated one or more of them. That being said, *allegations* of breach of duty are one thing, while *evidence* sufficient for plaintiffs to meet their burden of proof on the issue is another.[108]

As a practical matter, in motions to dismiss and other pre-trial legal challenges (e.g., motions for summary judgment), it may be difficult for defendants to "disprove" allegations of breach of duty so as to convince a court to terminate a lawsuit. Thus, for example, at the motion to dismiss stage, procedural rules require courts to assume the truth of the plaintiff's factual allegations, and allow dismissal only if the complaint nevertheless fails to state a valid claim as a matter of law.

In determining whether a fiduciary has in fact violated one or more of its duties, many courts have drawn on trust law considerations.[109] Thus, as a general matter, a fiduciary must be personally at fault, in the sense of acting negligently or intentionally, although in some cases simple mistakes may be sufficient to trigger a violation.[110]

Losses to the Plan and/or Ill-Gotten Gains

Section 409 further provides that there must be "losses to the plan" and/or ill-gotten profits to the fiduciary.

In order to survive pre-trial challenges on this issue, plaintiffs must establish at least a "prima

facie case" of plan loss or ill-gotten fiduciary profits.[111] It is not sufficient for plaintiffs to provide mere conjecture as to the possible existence of loss to a plan (and in such cases, defendants may be entitled to have the litigation terminated on a pre-trial motion to dismiss).[112]

As discussed above (see pages 24-25), prior to a recent Supreme Court decision, the courts had not definitively resolved the issue of whether losses to individual participant accounts in 401(k) and other defined contribution plans constitute losses "to a plan." It now appears that fiduciary liability may attach under section 502(a)(2)—and, by extension, under section 409—in such circumstances.[113]

Losses to a plan can include lost profits, since "make whole" relief under section 409 is designed to restore a plan to the position it would have had if no breach of fiduciary duty had occurred. Calculation of loss is rarely straightforward, and typically depends on a number of variables, including assumptions regarding how the plan would have performed absent the fiduciary's breach.[114]

Causation

Finally, section 409 provides that the plan losses and/or the fiduciary's ill-gotten profit must "result from" the fiduciary's breach of duty.

As a result, unless there is a breach of duty, a plan loss is not itself sufficient to establish monetary liability on the part of the fiduciary. Similarly, unless there is a plan loss (or an ill-gotten profit), a breach of duty is not itself sufficient to establish monetary liability on the part of the fiduciary.[115]

Moreover, even where there is both a breach of fiduciary duty and a plan loss (or an ill-gotten gain), fiduciary liability exists "only to the extent" that the breach is the "proximate cause" of such loss (or ill-gotten gain).[116] By implication, if a loss would have occurred whether or not a breach had occurred, the fiduciary generally will not be held responsible for such loss.[117]

Courts remain divided on the question of whether plaintiffs or defendants have the burden of proving causation.[118] In some courts, defendants bear the burden of demonstrating that their breach did not cause the loss or ill-gotten gain (or that there was no such loss or ill-gotten gain).[119] In other courts, the burden rests with plaintiffs.[120]

Safe Harbor Under Section 404(c)

Where, as is often the case, fiduciary litigation involves defined contribution plans, defendants frequently seek to rely on the so-called "safe harbor" established by section 404(c) of ERISA.

Section 404(c) exempts investment managers and other plan fiduciaries from liability for loss which results from a plan participant's (or beneficiary's) "exercise of control" over the assets in his or her individual account.[121] The DOL's implementing regulation for section 404(c) establishes detailed conditions and criteria that must be met in order for the safe harbor to attach.[122] The question of whether those conditions and criteria have been satisfied is frequently disputed by litigants.

Some courts have found that section 404(c) is an affirmative defense and not viable grounds for termination of a lawsuit on a motion to dismiss.[123] Accordingly, it may be difficult for defendants to invoke the safe harbor at early stages of the litigation process.

Key Areas of Litigation Risk

Outside the ERISA context, the most significant potential exposures for fund advisers and their affiliates in civil litigation tend to involve allegations of (1) inaccurate or incomplete disclosure; (2) improper receipt of fees or other compensation; (3) mismanagement of assets; or (4) other failures to adhere to fiduciary and/or contractual responsibilities. Fund shareholders or other plaintiffs may pursue such allegations under one or more provisions of the federal securities laws and/or state law.

Fund advisers and affiliates named as defendants in fiduciary litigation under ERISA tend to face these same basic types of allegations. Although the standards and criteria for civil liability under these parallel regimes—federal securities laws and state law, on the one hand, and ERISA, on the other—are similar in various respects, they are by no means identical.

The following discussion is designed to provide an overview of the basic obligations and attendant litigation risks that attach under ERISA to plan sponsors and plan service providers in each of these four areas, and to provide examples of some of the legal issues that arise in the context of litigation. The Appendix to this guide identifies selected fiduciary lawsuits involving fund advisers and their affiliates.

DISCLOSURE

Over the last decade, the plaintiffs' bar has initiated numerous shareholder lawsuits under the federal securities law challenging the adequacy of mutual fund disclosure.

Disclosure also features in fiduciary litigation under ERISA. More specifically, the question of whether a fiduciary has a duty to disclose—and, if so, the related questions of what should be disclosed and whether the defendant has in fact failed to make proper disclosure—are often contested in fiduciary litigation. Moreover, plaintiffs commonly invoke disclosure as an additional, or alternative, theory of legal recovery in fiduciary lawsuits alleging mismanagement of assets or improper receipt of fees.

Disclosures to Plan Participants

- ***Summary Plan Description ("SPD"):*** The SPD must, among other things, provide an explanation of plan features and benefits, information about the plan administrator and trustees, and a summary of the eligibility requirements to participate in the plan and to receive benefits. ERISA requires that the SPD be "written in a manner calculated to be understood by the average plan participant" and be "sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of their rights and obligations under the plan."[124]
- ***Plan's Annual Report:*** Plan participants must be provided with a summary of the latest annual report (Form 5500 Series) filed by the plan with the DOL, and are entitled to examine or receive a copy of the full report.[125] The annual report includes, among other things, the plan's financial statements, as well as disclosure regarding fee and compensation arrangements of plan service providers. Revisions to applicable DOL rules have increased required disclosure regarding fees and compensation received by plan providers from various sources (including mutual funds available as investment options under the plan).[126]
- ***Plan Documents:*** Plan participants are generally entitled to receive or examine copies of plan documents, as well as certain other materials relevant to plan operations (e.g., insurance contracts and collective bargaining agreements).[127]
- ***Fund Disclosure (404(c) Plans Only):*** As described above, certain plans rely on the "safe harbor" established by section 404(c) of ERISA. Such plans are required to provide plan participants with information about available investment alternatives, including prospectuses, financial statements, annual reports, and expense information.[128] (A proposed DOL regulation would, if adopted, require participant-directed contribution plans (whether or not the plans rely on the section 404(c) safe harbor) to disclose, or make available, similar information to plan participants.[129])

ERISA provides a "comprehensive set of 'reporting and disclosure' requirements" describing information that must be provided or made available to plan participants.[130] The requisite information is typically contained in the documents described in the sidebar above.

Courts have generally been reluctant to interpret the fiduciary provisions of ERISA (discussed above on page 16) as imposing an affirmative obligation on plan fiduciaries to disclose additional information beyond that required under the statute's "explicit disclosure requirements."[131] Thus, for example, some courts have rejected arguments that fiduciaries must disclose actuarial valuation reports, or that they must disclose proposed (but not yet implemented) changes to plan benefits.[132]

That being said, it is clear from U.S. Supreme Court precedent and from decisions by the lower courts "that *if* an ERISA fiduciary communicates information to plan participants, the fiduciary must be truthful," and that the fiduciary may not lie to participants or otherwise materially mislead them.[133] Apart from this broad prohibition on active misrepresentations, however, the Supreme Court has not provided definitive guidance in this area, and the Court has expressly declined to address "whether ERISA fiduciaries have any fiduciary duty to disclose truthful information on their own initiative, or in response to employee inquiries."[134]

As a result, the law remains unsettled as to whether a fiduciary may face civil liability for failures to disclose information that may be viewed by plan participants as material, where such information is not otherwise specifically required to be disclosed under the statute.[135] While some courts have found "an affirmative duty" on the part of an ERISA fiduciary "to inform when [it] knows that silence might be harmful,"[136] others have determined that this duty attaches only to information about plan *benefits,* and not to information about plan *investments*—i.e., not to "financial information about companies in which participants may invest."[137]

RECEIPT OF FEES AND COMPENSATION

In recent years, the plaintiffs' bar has initiated numerous shareholder lawsuits under the federal securities laws challenging the receipt by fund advisers and affiliates of fees and compensation. To date, the plaintiffs' bar has had limited success in these efforts.

Perhaps in the hope that ERISA will prove "a more viable route to pursue civil remedies … than the securities laws,"[138] the plaintiffs' bar has likewise in recent years initiated numerous fiduciary lawsuits under ERISA challenging fees and compensation. Brought as class actions on behalf of participants in 401(k) and other defined contribution plans, these lawsuits have charged plan sponsors and various plan service providers (including fund advisers and affiliates) with breaching their duties as fiduciaries under ERISA by permitting their plans to pay unreasonable (i.e., excessive) fees.

These lawsuits attack both payments made directly, in the form of fees paid by plans to service providers, and indirectly, in the form of "revenue sharing" (i.e., the receipt by plan service providers of compensation from mutual funds included as plan investment options and/or from affiliated entities serving as investment advisers to such funds).[139]

ERISA's exclusive benefit provision (see page 16) requires that a fiduciary act "solely in the interest" of plan participants and beneficiaries, and that the fiduciary act "for the exclusive purpose" of "providing benefits" to them and "defraying reasonable expenses of administering the plan." This provision is generally considered to mean that plan fiduciaries may permit only "reasonable" fees to be paid by the plan to plan service providers.[140]

ERISA's broadly worded prohibited transaction provisions (see pages 16-17) may also limit the ability of plan fiduciaries, and affiliates of fiduciaries, to provide services to ERISA plans (or underlying investment vehicles for plans). It follows that these provisions may likewise limit the ability of fiduciaries

and affiliates to receive compensation for such services.

Statutory and administrative exemptions under ERISA and DOL advisory opinions, however, have enhanced the ability of fund advisers and affiliates to provide services to ERISA plans and their underlying investment vehicles, and thus to receive compensation for these services. Certain of these exemptions are described above on pages 17-18.

In recent "revenue sharing" litigation, these exemptions and opinions have not tended to be at issue. Rather, the focus has been largely on whether defendants adequately considered "revenue sharing" payments when establishing "reasonable" fees with plan service providers.

PRUDENT MANAGEMENT OF ASSETS

Unlike the federal securities laws, which do not generally permit *direct* actions against advisers for alleged mismanagement of assets,[141] ERISA expressly contemplates that plan fiduciaries may be *directly* sued for mismanagement of assets under their control—i.e., for failure to adhere to their duty of "prudent management." Numerous fiduciary lawsuits charging imprudent investment have been initiated in recent years, in the aftermath of corporate accounting scandals (e.g., Enron, WorldCom), subprime events, and the credit crisis.

These lawsuits have been brought both as participant class actions against plan sponsors and various plan service providers, and as direct actions by plan fiduciaries (e.g., sponsors and administrators) against "third party" plan service providers (e.g., investment managers). Fund advisers or their affiliates have found themselves named as defendants in both types of lawsuits.

The duty to invest prudently encompasses two related fiduciary duties under ERISA:

(1) the duty to act with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims"—sometimes referred to as the "prudent expert" standard;[142] and

(2) the duty to "diversify[] the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[143]

Prudence

In considering whether a fiduciary has invested prudently, courts focus on the "primary question" of whether a fiduciary, "at the time [it] engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment."[144] In assessing whether a fiduciary has employed "appropriate methods" of investigation, courts look to the particular facts and circumstances involved, and may look to industry practices to help guide their decisions.[145]

Under relevant regulations adopted by the DOL, a prudent fiduciary must also (a) give "appropriate consideration" to the role of the proposed investment in the portfolio as a whole (or, if appropriate, in that portion of the portfolio for which the fiduciary is responsible); and (b) act accordingly. Factors relevant to such an "appropriate consideration" include:

(1) "the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties;"

(2) the risk of loss;

(3) the opportunity for gain; and

(4) other factors, including liquidity and diversification.[146]

Diversification

As a general matter, and with certain exceptions for ERISA plans that require or permit investments in employer stock,[147] ERISA's "duty to diversify prohibits a fiduciary from investing disproportionately in a particular investment or enterprise."[148] However, no bright-line test for assessing whether plan investments are adequately diversified has been established by ERISA, the courts, or the DOL.

To the contrary, courts have recognized that "ERISA's duty to diversify is not measured by hard and fast rules or formulas," and that diversification must be assessed in light of various relevant factors, including:

(1) the purposes of the plan;
(2) the amount of plan assets;
(3) financial and industrial conditions;
(4) the type of investment;
(5) geographic distribution;
(6) industry distribution; and
(7) dates of maturity.[149]

In assessing whether a fiduciary meets this duty, courts appear to consider both the adequacy of diversification of individual investment vehicles, and the overall adequacy of diversification of all investment vehicles within the segment of a plan for which the particular fiduciary (e.g., an investment manager) has responsibility.[150]

ADMINISTRATIVE AND CONSULTING SERVICES

The federal securities laws do not generally permit *direct* lawsuits against advisers for breach of fiduciary duty, and lawsuits must typically be structured as derivative actions under applicable state law.[151] By contrast, ERISA expressly contemplates that plan service providers—to the extent that they are fiduciaries within the meaning of ERISA—may be sued directly in federal courts for violating any of their broad-ranging fiduciary duties.

Plan service providers typically offer different types of "administrative" and "consulting" services to ERISA plans and plan participants. In providing many of these services, plan service providers frequently view their roles as ministerial and non-discretionary in nature, and they may therefore believe themselves to be acting in a non-fiduciary capacity. Yet providers of such services, as available "deep pockets," have been named as defendants in fiduciary litigation, and plaintiffs have sought to hold them accountable as ERISA fiduciaries.

Menu Selection

Affiliates of fund advisers may act as consultants, assisting plan fiduciaries (e.g., plan sponsors or administrators) to select investment options to be made available to plan participants. In many instances, the consultant's role is limited to identifying a menu of proposed investment options for the sponsor or administrator, and final authority to select the plan's particular investment options remains with the sponsor or administrator.

In fiduciary lawsuits initiated in the aftermath of investment losses, plaintiffs have included consultants as named defendants, alleging that the consultants acted as fiduciaries by effectively "selecting" plan investments. Courts in such cases have assessed the fiduciary status of consultants (including at the motion to dismiss stage of litigation[152]) through a fact-intensive review of relevant plan documents (including the consultant's contractual arrangements) and of the consultant's actual activities.[153] The assessment of a consultant's fiduciary status may also be affected in the future by a contemplated DOL rule that would, if adopted,

treat certain persons, including pension consultants and financial asset appraisers, as fiduciaries.[154]

Directed Trustees

It is not uncommon for affiliates of fund advisers to serve as "directed" trustees to ERISA plans. ERISA recognizes that trustees may act in a limited (or "directed") role, but requires that they be "subject to the direction of a named fiduciary," and be "subject to the proper instructions of such fiduciary … made in accordance with the terms of the plan and … not contrary to ERISA."[155] Directed trustees typically do not independently review purchase or sale transactions for a plan (other than for ministerial purposes) or second-guess directions or instructions that appear on their face to be proper.[156]

In past years, directed trustees, as potential "deep pockets," have been named as defendants in fiduciary lawsuits, particularly in the aftermath of employer collapses or other substantial plan losses.[157] In such cases, plaintiffs typically alleged, among other things, that the directed trustee should not have permitted investments in the employer's stock. Courts tended to assess a directed trustee's fiduciary status through a fact-specific examination of the terms of the trust instrument, the nature of the directions received, and/or the activities conducted by the directed trustee.[158]

In 2004, the DOL issued guidance on the fiduciary status of directed trustees. The DOL acknowledged that the responsibilities of directed trustees are "significantly narrower" than those of "discretionary" trustees. Yet the DOL also stated its views on the circumstances under which directed trustees may be obligated to inquire into, or question the prudence of, certain directions or instructions.[159]

Since the DOL issued its guidance, it appears that there has been no further litigation naming directed trustees as defendants. Nonetheless, a directed trustee may remain at risk of liability as a fiduciary if it is found to have followed directions that are not proper or that are contrary to the terms of the plan or to ERISA,[160] or if the directed trustee has discretionary authority.

Insurance Considerations

Broadly speaking, there are two basic types of ERISA-related insurance: fiduciary liability coverage and ERISA fidelity bond coverage.

- ***Fiduciary Liability Coverage:*** Section 410 of ERISA voids as against public policy any contractual provision that "purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty [under ERISA]."[161] However, the same section permits the purchase of fiduciary liability coverage to cover an ERISA plan or a fiduciary for losses resulting from breaches of fiduciary duty.[162]

  Broadly defined, "fiduciary liability" coverage insures against liabilities arising out of third-party claims brought against company-sponsored employee benefit plans, sponsoring companies themselves, and/or administrators or other providers to such plans, by reason of their breach of fiduciary duties under ERISA (and/or common and other statutory law) in providing plan services.

  Historically, "fiduciary liability" coverage has been viewed as separate and distinct from other types of liability coverages, including both "directors and officers" (D&O) coverage and "errors and omissions" (E&O) coverage.[163] Indeed, in the corporate arena, fiduciary liability coverage is often offered as a separate insurance product, and D&O and E&O coverages have traditionally reinforced this separation through use of express ERISA exclusions.[164] Nevertheless, D&O/E&O policy forms may themselves sometimes encompass one or more elements of fiduciary liability coverage.[165]

- ***ERISA Fidelity Bonds:*** Unlike fidelity liability coverage, which is not required under ERISA, the statute (at Section 412) generally mandates that plan fiduciaries and persons who handle plan funds or property be bonded.[166] Broadly speaking, ERISA bonding is intended to protect a plan from the risk of loss resulting from fraud or dishonesty by such entities and individuals.[167] ERISA coverage is typically provided either as a separate stand-alone bond or by supplementary coverage to other fidelity bonds.[168]

Appendix: Case List

This appendix lists selected lawsuits identified by ICI Mutual that, during the ten-year period ending December 31, 2009, were filed and/or resulted in a judicial disposition of an ERISA-based claim against a fund adviser and/or an affiliate. This list is not exhaustive. It generally omits (a) lawsuits against large corporations with in-house investment advisers, and (b) lawsuits against banks, insurance companies, or other large financial institutions whose investment adviser affiliates offer mutual funds.

The fourth column ("*Nature of Parties*") is intended to provide a summary description of the plaintiffs and the defendants in each lawsuit. Unless otherwise noted, a fund adviser or affiliate is listed as a "provider" for purposes of this column.

Case Name	*Venue*	*Filed*	*Nature of Parties*	*Subject*	*Disposition (as of Mar. 15, 2010)*
Blyler v. Agee	D. Ida.	1997	Participants v. sponsor & providers	prudent investment, directed trustee	settlement approved by court (Aug. 2004)
Franklin v. First Union Corp.	E.D. Va.	1999	Participants v. sponsor & providers	fees and compensation	settlement approved by court (June 2001)
Devlin v. Scardelletti	S.D.N.Y.	2000	Participants v. sponsor & providers	prudent investment	case dismissed by stipulation (Apr. 2000)
Riley v. Merrill Lynch, Pierce, Fenner & Smith, Inc.	M.D. Fla.	2000	Fiduciary v. providers	disclosure	dismissal (Sept. 2001) affirmed by Eleventh Circuit (July 2002); certiorari denied by Supreme Court (Oct. 2002)
Haddock v. Nationwide Fin. Servs., Inc.	D. Conn.	2001	Fiduciary v. provider	fees and compensation; menu selection	motion to dismiss denied (Sept. 2007)
In re Broadwing, Inc. ERISA Litig.	S.D. Ohio	2002	Participants v. sponsor, fiduciaries & providers	directed trustee	settlement approved by court (Oct. 2006)
Lalonde v. Textron, Inc.	D. R.I.	2002	Participants v. sponsor, fiduciaries & providers	directed trustee	motion for summary judgment granted (Mar. 2006); appeal voluntarily dismissed (Nov. 2006)
In re Mirant Corp. ERISA Litig.	N.D. Ga.	2003	Participants v. sponsor, fiduciaries & providers	directed trustee	settlement approved by court (Nov. 2006)
Ogden v. AmeriCredit Corp.	N.D. Tex.	2003	Participants v. sponsor, fiduciaries & providers	directed trustee	motion to dismiss granted (June 2005)

Case Name	*Venue*	*Filed*	*Nature of Parties*	*Subject*	*Disposition (as of Mar. 15, 2010)*
In re Admin. Comm. ERISA Litig.	N.D. Cal.	2004	Participants v. sponsor, fiduciaries & providers	directed trustee	case dismissed by stipulation (July 2006)
In re Mut. Funds Inv. Litig. (Judge Blake)	D. Md.	2004	Participants v. sponsor & fiduciaries	prudent investment	motion to dismiss granted in part and denied in part (as to one subtrack) (Dec. 2005)
In re Mut. Funds Inv. Litig. (Judge Davis)	D. Md.	2004	Participants v. sponsor & fiduciaries	prudent investment	motion to dismiss pending
In re Mut. Funds Inv. Litig. (Judge Motz)	D. Md.	2004	Participants v. sponsor & fiduciaries	prudent investment	motion to dismiss granted in part and denied in part (as to several subtracks) (Feb. 2006)
Beary v. Nationwide	S.D. Ohio	2006	Sponsor v. provider	fees and compensation	motion to dismiss granted (Sept. 2007); affirmed by Sixth Circuit (Feb. 2010)
Hecker v. Deere & Co.	W.D. Wisc.	2006	Participants v. sponsor, fiduciaries & providers	fees and compensation; disclosure; menu selection	dismissal (June 2007) affirmed by Seventh Circuit (July 2009); certiorari denied by Supreme Court (Jan. 2010)
Kanawi v. Bechtel Corp.	N.D. Cal.	2006	Participants v. sponsor, fiduciaries & providers	fees and compensation; menu selection	case dismissed without prejudice pursuant to settlement (Apr. 2009); appeal to Ninth Circuit dismissed pursuant to stipulation (July 2009)
Kennedy v. ABB	W.D. Mo.	2006	Participants v. sponsor, fiduciaries & providers	fees and compensation; menu selection	trial held (Jan. 2010); court ruling pending
Phones Plus, Inc. v. Hartford Fin. Servs., Inc.	D. Conn.	2006	Sponsor v. provider	menu selection	motion to dismiss (as to provider) granted by court (July 2009)
Columbia Air Servs., Inc. v. Fid. Mgmt. Trust Co.	D. Mass.	2007	Fiduciary v. provider	menu selection	motion to dismiss granted (Sept. 2008)
In re State Street Bank and Trust Co. ERISA Litig.	S.D.N.Y.	2007	Fiduciary v. provider	prudent investment	settlement approved by court (Feb. 2010)
Martin v. Caterpillar Inc.	C.D. Ill.	2007	Participants v. sponsor, fiduciaries & providers	fees and compensation; prudent investment; menu selection	motion for preliminary approval of settlement pending before court (Nov. 2009)
Renfro v. Unisys Corp.	E.D. Penn.	2007	Participants v. sponsor, fiduciaries & providers	fees and compensation; menu selection	motion to dismiss pending

Case Name	*Venue*	*Filed*	*Nature of Parties*	*Subject*	*Disposition (as of Mar. 15, 2010)*
Ruppert v. Principal Life Ins. Co.	S.D. Iowa	2007	Fiduciary v. provider	fees and compensation; menu selection	motion for judgment on pleadings granted (Nov. 2009); motion to reconsider order pending
IATSE Local 33 Section 401(k) Plan Board of Trustees v. Bullock	C.D. Cal.	2008	Fiduciary v. providers	fees and compensation	ERISA claims dismissed with prejudice (Jan. 2009); state law claims dismissed without prejudice (Jan. 2009)
In re Honda of Am. Mfg., Inc. ERISA Fees Litig.	S.D. Ohio	2008	Participants v. sponsor, fiduciaries & providers	fees and compensation; disclosure; menu selection; prudent investment	motion to dismiss granted (Oct. 2009)
Williams v. Regions Fin. Corp.	N.D. Ala.	2008	Participants v. sponsor & providers	menu selection	motion to dismiss granted (Aug. 2008)
Board of Trs. of the Carpenters Labor Mgmt. Pension Fund v. State Street Bank & Trust Co.	S.D.N.Y.	2009	Fiduciaries v. fiduciary (adviser as plan manager)	prudent investment	motion to dismiss pending
In re Regions Morgan Keegan Securities, Derivative and ERISA Litig.	W.D. Tenn.	2009	Participants vs. sponsor & providers	prudent investment	motion to dismiss not yet filed
St. Vincent Catholic Med. Ctrs. v. Morgan Stanley Inv. Mgmt.	S.D.N.Y.	2009	Fiduciary v. fiduciary (adviser as plan manager)	prudent investment	motion to dismiss pending

Endnotes

1 *See* Turner v. Turner, 672 S.E.2d 242, 254-55 (W. Va. 2008) ("the unfathomable morass called ERISA"); York v. Ramsay Youth Servs., 313 F. Supp. 2d 1275, 1280 (M.D. Ala. 2004) ("the morass that is ERISA law"); Nichols v. Se. Health Plan, 859 F. Supp. 553, 558 (S.D. Ala. 1993) ("Given the complexity of the ERISA statutory and regulatory scheme …."). One federal appellate judge—in an oft-quoted analogy—has characterized the struggle of lower courts to make sense of one particular ERISA provision as a "descent into a Serbonian bog," invoking the quagmire of legend between Egypt and Palestine where, in the words of the poet John Milton, "armies whole have sunk." DiFelice v. Aetna U.S. Healthcare, 346 F.3d 442, 454 (3d Cir. 2003) (citation omitted).

2 *See* BD. OF GOVERNORS OF THE FED. RES. SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: 1965-1974, at 90 (2009), *available at* http://www.federalreserve.gov/releases/z1/Current/annuals/a1965-1974.pdf, at 90 ($367.5 billion of pension fund reserves in 1974); Inv. Co. Inst., *The U.S. Retirement Market, Third Quarter* 2009, RES. FUNDAMENTALS, Feb. 2010, at 1 [hereinafter *U.S. Retirement Market 2009*].

3 Unless otherwise noted, this study uses the term "retirement plans" to refer to both retirement plans, such as 401(k) plans, and to retirement accounts, such as individual retirement accounts.

4 *See generally* Faircloth v. Lundy Packing Co., 91 F.3d 648, 661-62 (4th Cir. 1996) (Michael, J., concurring in part and dissenting in part) (describing differences between defined benefit plans and defined contribution plans).

5 *See* William G. Gale et al., *The Shifting Structure of Private Pensions*, *in* THE EVOLVING PENSION SYSTEM: TRENDS, EFFECTS, AND PROPOSALS FOR REFORM 51, 56 (William G. Gale et al. eds., 2005); Samuel Estreicher & Laurence Gold, *The Shift from Defined Benefit Plans to Defined Contribution Plans*, 11 LEWIS & CLARK L. REV. 331, 332-33 (2007).

6 Estreicher & Gold, *supra* note 5, at 331-32; *see, e.g.*, *U.S. Retirement Market 2009*, *supra* note 2, at 14 (in 1985, defined contribution plan assets and defined benefit plan assets were approximately $500 billion and over $800 billion, respectively; by the third quarter of 2008, defined contribution plan assets and defined benefit plan assets were in excess of $3.9 trillion and $2.1 trillion, respectively).

7 *See U.S. Retirement Market 2009*, *supra* note 2, at 14. A full discussion of reasons for the decline of defined benefit plans is beyond the scope of this guide. Some industry observers have cited, among other things, changes in the composition of the labor force, shifts in the U.S. economy, and regulatory developments. *See, e.g.*, Gale et al., *supra* note 5, at 62-65.

8 *See U.S. Retirement Market 2009*, *supra* note 2, at 14.

9 *See* Estreicher & Gold, *supra* note 5, at 334.

10 Less commonly for some 401(k) plans, the plan trustee or other named fiduciary is responsible for investing some or all of the plans' assets. Approximately 87% of 401(k) plans (representing over 90% of both plan participants and plan assets) are participant-directed. U.S. GEN. ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES, PUBL'N NO. GAO-07-21, at 5 (2006); *see also* William J. Wiatrowski, *401(k) Plans Move Away from Employer Stock as Investment Vehicle*, MONTHLY LAB. REV., Nov. 2008, at 3-4, *available at* http://www.bls.gov/opub/mlr/2008/11/art1full.pdf (noting that, as of 2005, 91% of 401(k) plans permitted employees to direct the investment of *employee* contributions, but only 76% of such plans permitted employees to direct the investment of *employer* contributions); DOL, REPORT OF THE WORKING GROUP ON PARTICIPANT BENEFIT STATEMENTS, *available at* http://www.dol.gov/ebsa/publications/AC-1107c.html (last visited Feb. 9, 2010) (noting that some 401(k) plans may be partially participant-directed).

11 *See U.S. Retirement Market 2009*, *supra* note 2, at 10.

12 As of 2005, slightly over 20% of plan participants were permitted to invest in employer stock. *See* Wiatrowski, *supra* note 10, at 5-6.

[13] *See U.S. Retirement Market 2009*, *supra* note 2, at 5-6. The remaining assets in IRAs are primarily securities held directly through brokerage accounts; bank and thrift deposits; and annuities issued by life insurance companies. *See id.*

[14] *See* U.S. GEN. ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT PENSIONS PLANS, PUBL'N NO. GAO-08-983T, at 12-13 (2008), *available at* http://www.gao.gov/new.items/d08983t.pdf (testimony before the Joint Economic Committee) (describing constitutional and statutory protections provided by various states); *see also, e.g.*, FLA. STAT. §§ 112.60-112.67 (known as the "Florida Protection of Public Employee Retirement Benefits Act").

[15] *See* ERISA § 3(42) (codified at 29 U.S.C. § 1102(42) (2006)); 29 C.F.R. § 2510.3-101 (2009). *See also* Richard K. Matta, Groom Law Group, ERISA for Securities Professionals, Dec. 2008, at 3-4, http://www.groom.com/media/publication/439_ERISA%20for%20Securities%20Professionals%20December%202008%20final.pdf (describing look-through provisions).

[16] *See* 29 C.F.R. § 2510.3-101(h) (2009).

[17] *But see Fiduciary Role Looms for Target-Date Managers*, PENSIONS & INVESTMENTS, Dec. 14, 2009, http://www.pionline.com/article/20091214/PRINTSUB/312149976 (discussing possible future legislation regarding the application of ERISA to advisers of certain target-date funds).

[18] *See* ERISA § 401(b)(1) (codified at 29 U.S.C. § 1101(b)(1) (2006)) (providing that fund assets are not plan assets solely by reason of a plan's holding of a security issued by such fund); ERISA § 3(21)(B) (codified at 29 U.S.C. § 1001(21)(B) (2006)) (providing that fund assets are not plan assets "except insofar as such [fund] or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the [fund], the investment adviser, or its principal underwriter").

[19] *See* Matta, *supra* note 15, at 3-4.

[20] In re Citigroup ERISA Litig., No. 07 Civ. 9790, 2009 U.S. Dist. LEXIS 78055, at *19 (S.D.N.Y. Aug. 31, 2009).

[21] *See* ERISA § 402(b) (codified at 29 U.S.C. § 1102(b) (2006)).

[22] *See* ERISA § 402(c) (codified at 29 U.S.C. § 1102(c) (2006)).

[23] *See* ERISA § 403(a) (codified at 29 U.S.C. § 1103(a) (2006)). Certain assets (e.g., insurance contracts or policies) and plans (e.g., plans consisting of certain IRAs) are exempt from the requirement of ERISA § 403(a). *See* ERISA § 403(b) (codified at 29 U.S.C. § 1103(b) (2006)).

[24] *See* ERISA § 3(16)(B) (codified at 29 U.S.C. § 1002(16)(B) (2006)).

[25] *See* Lockheed Corp. v. Spink, 517 U.S. 882, 890-91 (1996); *see also* U.S. Gen. Accountability Office, Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors, Publ'n No. GAO-08-774, at 12 n.15 (2008).

[26] *See* TOWERS PERRIN, QUALIFIED RETIREMENT PLAN GOVERNANCE: 2008 SURVEY FINDINGS 4 (2008) (noting that, of the companies surveyed, 47% have a single committee that handles administration and investment functions, 46% have separate administration and investment committees, and 1% have no committees).

[27] *See* ERISA § 3(16)(A) (codified at 29 U.S.C. § 1002(16)(A) (2006)).

[28] *See* ERISA § 403(a) (codified at 29 U.S.C. § 1103(a) (2006)).

[29] *See* ERISA § 3(38) (codified at 29 U.S.C. § 1102(38) (2006)).

[30] *See* Am. Acad. of Actuaries, Fundamentals of Current Pension Funding and Accounting for Private Sector Pension Plans 3-5 (2004), http://www.actuary.org/pdf/pension/fundamentals_0704.pdf.

[31] *See* DOL, Reasonable Contract or Arrangement under Section 408(b)(2) – Fee Disclosure, 72 Fed. Reg. 70,988, 70,991 (proposed Dec. 13, 2007) [hereinafter Reasonable Contract Release].

[32] *See id.* Under ERISA, a platform provider is not generally required to break down the aggregate fee on a service-by-service basis or to disclose compensation to affiliates or subcontractors. A DOL proposal may, however, depending on the final rules, require a bundled service provider to provide separate disclosure of certain fees (e.g., a mutual fund advisory or distribution fee charged directly against the plan's investment that is reflected in the net value of the investment). *See id.* In addition, under Schedule C of Form 5500, a bundled service provider is required to disclose certain fees. *See* DOL, Annual Reporting and Disclosure, 72 Fed. Reg. 64,710 (Nov. 16, 2007); DOL, Revision of Annual Information Return/Reports, 72 Fed. Reg. 64,731 (Nov. 16, 2007).

[33] *See, e.g.*, Inv. Co. Inst., The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2008, at 4 (2009) (describing broad categories of services to 401(k) plans) .

[34] *See 2009 PlanSponsor Recordkeeping Survey: Picking the Best Provider*, PLANSPONSOR, June 2009, *available at* http://www.plansponsor.com/MagazineArticle.aspx?id=64424562868 (indicating that at least two-thirds of the top ten record keepers for defined contributions plans were fund advisers or adviser affiliates); DELOITTE LLP, DEFINED CONTRIBUTION/401(K) FEE STUDY 10 (2009), *available at* http://www.ici.org/pdf/rpt_09_dc_401k_fee_study.pdf (over 50% of defined contribution plans surveyed used fund advisers and affiliates for record keeping services).

[35] In recent years, there have been proposals—which have not yet been adopted—that would permit service providers to provide more individualized investment advice to plan participants without being treated as fiduciaries or otherwise engaged in prohibited transactions. The Pension Protection Act of 2006 (the "PPA") amended ERISA and the Code to facilitate the provision of investment advice to plan participants and beneficiaries. As amended by the PPA, ERISA permits investment advice to be given either (1) through the use of a computer model (certified to be unbiased) or (2) through an adviser compensated on a level-fee basis, and subject to certain additional requirements (e.g., disclosure requirements). DOL rules under the PPA's provisions have yet to be implemented.

[36] A plan provider's own assessment as to its fiduciary status is not necessarily conclusive. One proposed DOL regulation would require each service provider to an ERISA plan to disclose information to assist the plan fiduciary responsible for selecting or monitoring that service provider with assessing both (1) the reasonableness of the compensation or fees paid for the service provider's services to the plan and (2) the potential for conflicts of interest that may affect the service provider's performance of services. *See* Reasonable Contract Release, *supra* note 31, at 70,991. The proposed rule would also require a service provider's contract to identify whether the service provider would act or provide services to the plan *as a fiduciary*. The proposed rule does not, by its terms, purport to broaden the scope of the term "fiduciary" under ERISA. At the same time, however, under the proposed rule, the DOL (and presumably a court) would *not* view as dispositive the contractual statement as to whether a service provider is or is not a fiduciary. Rather, consistent with its historical "functional" approach to the question of fiduciary status, the DOL would continue to take the position that "fiduciary status depends on a factual analysis of a person's activities with respect to a plan." *Id.* at 70,991 n.11.

[37] John H. Langbein, *What ERISA Means by "Equitable": The Supreme Court's Trail of Error in* Russell, Mertens *and* Great-West, 103 COLUM. L. REV. 1317, 1321-22 (Oct. 2003); *see also* Michael S. Gordon, *Overview: Why Was ERISA Enacted?, in* THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: THE FIRST DECADE (Special Comm. on Aging, U.S. Sen. ed., 1984); DOL, HISTORY OF EBSA AND ERISA, *available at* http://www.dol.gov/ebsa/aboutebsa/history.html (last visited Feb. 9, 2010) [hereinafter HISTORY OF EBSA AND ERISA] (discussing federal regulation of retirement plans prior to ERISA).

[38] *See* Shaw v. Delta Airlines, Inc., 463 U.S. 85, 90 (1983).

[39] *See* Langbein, *supra* note 37, at 1322 (describing these two broad types of risk); Pension Benefit Guar. Corp. v. R.A. Gray & Co., 467 U.S. 717, 720 (1984) ("Among the principal purposes of … [ERISA] was to ensure that employees and their beneficiaries would not be deprived of anticipated retirement benefits by the termination of pension plans before sufficient funds have been accumulated in the plans. Congress wanted to guarantee that 'if a worker has been promised a defined pension benefit upon retirement – and if he has fulfilled whatever conditions are required to obtain a vested benefit – he actually will receive it.'") (citations omitted).

[40] *See* Langbein, *supra* note 37, at 1322.

[41] Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 361-62 (1980).

[42] *See, e.g.*, 26 U.S.C. §§ 404 (providing employer with deduction for contributions to an employees' trust or annuity plan and compensation under a deferred-payment plan), 501(a) (exempting retirement plan trusts from taxation).

[43] *See generally* HISTORY OF EBSA AND ERISA, *supra* note 37.

[44] As one court has stated, ERISA has "a raft of provisions designed to protect plan participants against negligent or malfeasant plan managers." *See DiFelice*, 346 F.3d at 454.

[45] Under ERISA, "parties in interest" of a plan include plan fiduciaries, service providers to the plan, employers whose employees are plan participants, employee organizations whose members are plan participants, and certain affiliates thereof. ERISA § 3(14) (codified at 29 U.S.C. § 1002(14) (2006)). ERISA prohibits certain transactions between a plan and a party in interest. *See* ERISA § 406(a) (codified at 29 U.S.C. § 1106(a) (2006)).

[46] ERISA § 3(21)(A) (codified at 29 U.S.C. § 1002(21)(A) (2006)) provides, in relevant part, that "a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan."

[47] *See* Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110-11 (1989).

[48] At the same time, the Supreme Court has cautioned, "trust law does not tell the entire story," such that "the law of trusts often will inform, but will not necessarily determine the outcome of, an effort to interpret ERISA's fiduciary duties." *See* Varity Corp. v. Howe, 516 U.S. 489, 497 (1995)

[49] *See, e.g.*, ERISA § 404(a)(1) (codified at 29 U.S.C. § 1104(a)(1) (2006)).

[50] *See, e.g.*, In re Citigroup ERISA Litig., No. 07 Civ. 9790, 2009 U.S. Dist. LEXIS 78055, at *19 (S.D.N.Y. Aug. 31, 2009).

[51] *See* ERISA § 3(21)(A) (codified at 29 U.S.C. § 1002(21)(A) (2006)).

[52] *See* Hecker v. Deere & Co., 556 F.3d 575, 581 (7th Cir. 2009) ("Thus, even if the Fidelity defendants were fiduciaries for some purposes, they were not fiduciaries for the purpose of making plan investment decisions."), *cert. denied* 175 L. Ed. 2d 973 (U.S. 2010).

[53] ERISA § 404(a)(1) (codified at 29 U.S.C. § 1104(a)(1) (2006)).

[54] *Id.*

[55] *See* Matta, *supra* note 15, at 32 (noting that courts have found non-fiduciary parties in interest to be subject to claims for equitable relief).

[56] *See* ERISA § 406(b) (codified at 29 U.S.C. § 1106(b) (2006)). The Code includes similar prohibitions. *See* 26 U.S.C. § 4975 (2006).

[57] *See* ERISA § 406(a) (codified at 29 U.S.C. § 1106(a) (2006)).

[58] *See* 26 U.S.C. § 4975 (2006).

[59] ERISA § 408(b)(2) (codified at 29 U.S.C. § 1108(b)(2) (2006)); 29 C.F.R. § 2550.408b-2(a) (2009). Note, however, that "[c]ourts have diverged over whether [the referenced DOL] regulation accurately interprets the statute." Dupree v. Prudential Ins. Co. of Am., No. 99 Civ. 8337, 2007 U.S. Dist. LEXIS 57857, at *135 (S.D. Fla. Aug. 7, 2007) (citations omitted).

[60] The exemption for blind transactions effected on securities exchanges was not expressly provided for in the statute, but arose from the DOL's interpretation of ERISA's legislative history, which states: "In general, it is expected that a transaction will not be a prohibited transaction (under either the labor or tax provisions) if the transaction is an ordinary 'blind' transaction purchase or sale of securities through an exchange where neither buyer or seller (nor the agent of either) knows the identity of the other party involved. In this case, there is no reason to impose a sanction on a fiduciary (or party-in-interest) merely because, by chance, the other party turns out to be a party-in-interest (or plan)." H.R. REP. NO. 93-1280, at 307 (1974), *cited in* DOL Advisory Opinion 92-23A (Oct. 27, 1992). The PPA appears to have both codified the DOL's interpretation and extended the exemption to cover blind transactions effected on alternative trading systems, electronic communications networks, and similar execution systems or trading venues. *See* ERISA § 408(b)(16) (codified at 29 U.S.C. § 1108(b)(16)).

[61] ERISA § 408(b)(17) (codified at 29 U.S.C. § 1108(b)(17) (2006)).

[62] *See* Prohibited Transaction Class Exemption 77-3, 42 Fed. Reg. 18,734 (Apr. 8, 1977).

[63] *See* Prohibited Transaction Class Exemption 77-4, 42 Fed. Reg. 18,732 (Apr. 8, 1977).

[64] *See* Prohibited Transaction Class Exemption 84-14, 49 Fed. Reg. 9,494 (Mar. 13, 1984).

[65] *See* Prohibited Transaction Class Exemption 96-23, 61 Fed. Reg. 15,975 (Apr. 10, 1996).

[66] *See* Matta, *supra* note 15, at 20-21.

[67] *See* ERISA Procedure 76-1 for ERISA Advisory Opinions, 76 Fed. Reg. 25,168 (Aug. 26, 1976), *available at* http://www.dol.gov/ebsa/regs/aos/ao_requests.html (describing purpose of advisory opinions and information letters; EMPLOYEE BENEFITS SECURITY ADMINISTRATION RELEASES FIELD ASSISTANCE BULLETIN ON ANNUAL REPORTING BY 403(B) PLANS (Jul. 20, 2009), *available at* http://www.dol.gov/ebsa/newsroom/2009/ebsa072009.html (providing description of role of field assistance bulletins). *See generally* 29 C.F.R. § 2509 (providing interpretive bulletins relating to ERISA).

[68] *See* Op. DOL 97-15A (1997) ("Frost" letter); Op. DOL 97-16A (1997) ("Aetna letter"); Op. DOL 2003-09A (2003) ("ABN-AMRO letter").

[69] Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41, 54 (1987).

[70] Mass. Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 146 (1985).

[71] *See, e.g.*, *Pilot Life*, 481 U.S. at 56 (civil enforcement scheme codified at section 502(a) is not to be supplemented by state-law remedies).

[72] *See, e.g.*, DOL, Fact Sheet: EBSA Achieves $1.36 Billion in Total Monetary Results in Fiscal Year 2009, *available at* http://www.dol.gov/ebsa/newsroom/fsFYagencyresults.html (last visited Mar. 15, 2010) (noting that, in fiscal year 2009, EBSA closed nearly 3,700 investigations, with approximately 77% of the closed investigations yielding monetary results for the plans or other corrective action).

[73] *See* PENSION GOVERNANCE INC. & THE MICHEL-SHAKED GROUP, ERISA LITIGATION STUDY (2009), *available at* http://www.pensionriskmatters.com/uploads/file/PLD%20ERISA%20Litigation%20Study%20041509%282%29.pdf (noting that over 2,400 ERISA cases were filed between Jan. 1, 2005 and Aug. 31, 2008).

[74] *See* Samuel Estreicher & Kristina Yost, Measuring the Value of Class and Collective Action Employment Settlements: A Preliminary Assessment, N.Y.U. Law Sch. Pub. Law Res. Paper No. 08-03, Jan. 23, 2009, at 8 *available at* http://ssrn.com/abstract=1080567; SEYFARTH SHAW LLP, 2010 ANNUAL WORKPLACE CLASS ACTION LITIGATION REPORT 7 (2010) (full report on file with ICI Mutual; press release describing report available at http://www.seyfarth.com/ClassActionReport/ (follow "View press release" hyperlink)) (reporting that, in 2009, settlement payments in the ten largest ERISA class action lawsuits totaled nearly $500 million).

[75] These lawsuits are often brought under section 502(a)(1) of ERISA (codified at 29 U.S.C. § 1132(a)(1) (2006)), which addresses wrongful denial of plan benefits and information (e.g., annual reports), and authorizes participants and beneficiaries to pursue lawsuits to recover benefits or to obtain information.

[76] *See, e.g.*, Alexander v. Wash. Mut. Inc., No. 07 Civ. 01905 (W.D. Wash. Mar. 18, 2007); In re Morgan Stanley ERISA Litig., No. 07 Civ. 11285 (S.D.N.Y. filed Dec. 14, 2007).

[77] *See* Kevin LaCroix, *Subprime Litigation Wave Hits State Street*, THE D&O DIARY, Jan. 6, 2008, http://www.dandodiary.com/2008/01/articles/subprime-litigation/subprime-litigation-wave-hits-state-street/.

[78] *See* Sean M. Murphy et al., *Securities Plaintiffs Turn to Class Actions Under ERISA*, REV. OF SECS. & COMMODITIES REG., at 15, Sept. 3, 2008, *available at* http://www.milbank.com/NR/rdonlyres/A877583C-CD17-4DB1-9520-7F95F8EB8184/0/090308_Securities_Plaintiffs_Turn_to_Class_Actions_Under_ERISA.pdf.

[79] James P. Baker & Alan S. Miller, *Making Employer Stock Safe for Your 401(k) Plan: Managing the Risk*, JONES DAY PUBL'NS, Feb. 2007, http://www.jonesday.com/files/Publication/bfab9891-dfca-4dd0-8335-9c238ed2d172/Presentation/PublicationAttachment/da8c26eb-ae23-456b-804c-749d15dfe809/Making%20Employer.pdf, at 3.

[80] This appeal may stem, in part, from:

- *Certain procedural advantages in litigation:* Unlike class action litigation brought under the federal securities laws, *see* section 27(b) of the Securities Act of 1933 (codified at 15 U.S.C. § 77z-1(b) (2006)); section 21D(b)(3) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. § 78u-4(b)(3) (2006)), ERISA-based lawsuits are not subject to a suspension, or "stay," on the discovery (i.e., fact-finding) phase of litigation pending a decision by a court on a defendant's motion to dismiss.
- *Difficulty in resolving litigation on motions to dismiss:* Although ERISA lawsuits can be—and in some cases are—terminated on defendants' pre-trial motions to dismiss, many turn in part on issues (such as a defendant's status as a "fiduciary") that may be fact-intensive and difficult for courts to resolve at this early stage of the litigation process. (See, for example, the discussion of lawsuits relating to administrative and consulting services at pp. 31-32.)
- *Prospects for settlements:* According to one observer, "a slew of generous settlements" in the ERISA area are among the factors that have "conditioned the plaintiffs' bar to demand settlements" in ERISA lawsuits that "are hard to justify on a litigation risk basis." *See* Charles C. Jackson & Christopher A. Weals, *The Pro-Fiduciary Trial Ruling in* DiFelice v. US Airways*, and What It Means for ERISA Stock Litigation*, PLUS J., at 1, Sept. 2006, *available at* http://www.morganlewis.com/pubs/Pro-FiduciaryTrial_sept2006.pdf.

[81] Baker et al., *supra* note 79, at 1.

[82] *See* Kevin LaCroix, *Defense Prevails in Tellabs ERISA Stock Drop Case*, THE D&O DIARY, Jun. 18, 2009, http://www.dandodiary.com/2009/06/articles/erisa/defense-prevails-in-tellabs-erisa-stock-drop-case/ ("A frequent securities class action lawsuit accompaniment is a companion ERISA stock drop lawsuit brought on behalf of employee participants in the defendant company's benefit plan. These ERISA lawsuits have in recent years resulted in a string of impressive settlements…."); *see also* James O. Fleckner, Current Developments in ERISA Litigation, Goodwin Procter LLP Presentation to Strafford Teleconference, Apr. 7, 2009, at 3, http://media.straffordpub.com/products/erisa-class-action-lawsuits-on-the-rise-2009-04-07/presentations.pdf.

[83] *See, e.g.*, ICI MUT. INS. CO., INVESTMENT MANAGEMENT LITIGATION NOTEBOOK 67-73 (5th ed. 2007) (describing ERISA litigation that accompanied market timing litigation primarily brought under the federal securities laws).

[84] *See* LaCroix, *supra* note 77.

[85] *See, e.g.*, In re State Street Bank and Trust Co. ERISA Litig., No. 07 Civ. 8488 (S.D.N.Y. filed Oct. 1, 2007) (plaintiffs' counsel include both "Wall Street" law firms and firms normally associated with the plaintiffs' bar).

[86] *See* LaCroix, *supra* note 77.

[87] *See* Rogers v. Baxter Int'l Inc., 521 F.3d 702, 705 (7th Cir. 2008).

[88] *See, e.g.*, Jenkins v. Yager, 444 F.3d 916, 924 (7th Cir. 2006).

[89] ERISA § 2(b) (codified at 29 U.S.C. § 1001(b) (2006)).

[90] Mass. Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 146 (1985).

[91] In addition to standing requirements established under ERISA, there are also constitutional standing requirements, which include a showing that any potential plaintiff has suffered an "injury in fact." *See, e.g.*, Lujan v. Defenders of Wildlife, 504 U.S. 555, 561 (1992) (describing three elements of constitutional standing in U.S. Supreme Court jurisprudence: injury in fact, causation, and judicial redressability).

[92] *See* 29 U.S.C. § 1132(a)(2) (2006).

93 *See* 29 U.S.C. § 1132(a)(3) (2006); Varity Corp. v. Howe, 516 U.S. 489, 512 (1996) (describing section 502's "overall structure"). As discussed *supra* note 75 and accompanying text, a third enforcement provision of ERISA, section 502(a)(1) (codified at 29 U.S.C. § 1132(a)(1) (2006)), can also implicate fund advisers and their affiliates, although the liability risks associated with lawsuits under this section tend to be less pronounced, given the section's purpose and scope.

94 *See* LaRue v. DeWolff, Boberg & Assocs., 552 U.S. 248 (2008). Some observers saw *LaRue* as a revolutionary development, "open[ing] the door to a new category of ERISA lawsuits." *See, e.g.*, *Supreme Court Addresses the Remedies Available for Fiduciary Breach Under ERISA*, MONDAQ BUSINESS BRIEFING, Feb. 29, 2008, http://www.highbeam.com/doc/1G1-175684720.html (quoted above); Kevin LaCroix, *The* LaRue *Decision: ERISA Liability and Insurance Issues*, THE D&O DIARY, Feb. 21, 2008, http://www.dandodiary.com/2008/02/articles/erisa/the-larue-decision-erisa-liability-and-insurance-issues/. Other observers viewed the decision as simply confirming a pre-existing trend in the lower courts. *See, e.g.*, Thelen LLP, *Supreme Court Holds that ERISA Authorizes Individual Suits for Lost-Profits Damages in Defined Contribution Plan Caused by Breach of Fiduciary Duty*, CLIENT ALERT, Feb. 28, 2008, http://www.thelenreid.com/index.cfm?section=articles&function=ViewArticle&articleID=3371&filter=.

95 The Court stated that section 502(a)(2) (codified at 29 U.S.C. § 1132(a)(2) (2006)) permits "recovery for fiduciary breaches that impair the value of plan assets in a participant's individual account." *LaRue*, 552 U.S. at 256 (2008).

96 *See* In re Mut. Funds Inv. Litig., 529 F.3d 207, 216 (4th Cir. 2008) ("In short, we conclude that participants in defined contribution plans controlled by ERISA have colorable claims against the fiduciaries of their plan when they allege that their individual accounts in the plan were diminished by fraud or fiduciary breaches and that the amounts by which their accounts were diminished constitute part of the participants' benefits under the plans.").

97 For a discussion of class certification issues, see Mark A. Perry & Paul Blankenstein, *The Inapplicability of Rule 23(b)(1) to ERISA Class Actions*, 6 WORKPLACE L. REP. 47, at 1571-75 (2008), *available at* http://www.gibsondunn.com/publications/Documents/Perry-Blankenship-ERISAClassActions.pdf. The U.S. Court of Appeals for the Seventh Circuit is currently reviewing *LaRue*'s effect, if any, on the grant by district courts of class certification in two ERISA "stock drop" lawsuits and two ERISA "excess fee" lawsuits. *See* Howell v. Motorola Inc., No. 07-3837 (7th Cir. Aug. 17, 2009) (consolidation order); Lingis v. Dorazil, No. 09-2796, (7th Cir. Aug. 17, 2009) (consolidation order); Spano v. Boeing Co., No. 09-3001, (7th Cir. Aug. 17, 2009) (consolidation order); Beesley v. Int'l Paper Co., No. 09-3018, (7th Cir. Aug. 17, 2009) (consolidation order).

Other unresolved questions include (1) whether plan participants must exhaust administrative remedies before initiating their lawsuits, and (2) whether plaintiffs are entitled to jury trials. *See generally* COVINGTON & BURLING LLP, *Notable Recent Decisions in ERISA Litigation*, Nov. 2008, http://www.cov.com/publications/?Practices=f0bd8f37-1599-4ca5-bf37-33f44e100bd0&search=1 (follow "Notable Recent Decisions in ERISA Litigation" hyperlink) (noting that courts have not uniformly required exhaustion of administrative remedies in lawsuits alleging breaches of fiduciary duties); Brief for the United States as Amicus Curiae, Amschwand v. Spherion Corp., 505 F.3d 342 (5th Cir. 2007) (No. 07-841) (noting conflicting decisions by district courts regarding availability of jury trials in breach of fiduciary duty cases under ERISA).

98 *See generally* Langbein, *supra* note 37 (describing recent ERISA jurisprudence regarding the meaning of "other appropriate equitable relief" under section 502(a)(3)).

99 Indeed, a "threshold question" in "every case charging breach of ERISA duty" is whether the defendant "was acting as a fiduciary (that is, was performing a fiduciary function) when taking the action subject to complaint." Pegram v. Herdrich, 530 U.S. 211, 226 (2000).

100 *See* ERISA § 405(a) (codified at 29 U.S.C. § 1104(a) (2006)).

101 *See id.*

102 *See* Harris Trust & Sav. Bank v. Salomon Smith Barney Inc., 530 U.S. 238, 251 (2000) (holding that a non-fiduciary service provider to a plan can be liable under section 502(a)(3) of ERISA for participating in a prohibited transaction where the service provider "had actual or constructive knowledge of the circumstances that rendered the transaction unlawful" and where "the *plan fiduciary*, with actual or constructive knowledge of the facts satisfying the elements of a [prohibited transaction between a plan and a party in interest], caused the plan to engage in the transaction") (emphasis in original).

[103] *See* ERISA § 3(21)(A) (codified at 29 U.S.C. § 1002(21)(A)); In re Citigroup ERISA Litig., No. 07 Civ. 9790, 2009 U.S. Dist. LEXIS 78055, at *20-21 (S.D.N.Y. Aug. 31, 2009) (discussing named and functional fiduciaries).

[104] *See* Groom Law Group, Chartered, *401(k) Fee Litigation Update*, Oct. 6, 2008, http://www.groom.com/assets/attachments/CourtsDividonFiduciary_Statusof401kServiceProviders.pdf.

[105] *See* Varity Corp. v. Howe, 516 U.S. 489, 511 (1996).

[106] ERISA § 409(a) (codified at 29 U.S.C. § 1109(a) (2006)).

[107] Thus, for example, while some courts have found a duty to disclose certain information to plan participants where such disclosure is not otherwise mandated by ERISA, the courts have disagreed on the circumstances that would trigger the duty. *See generally* Vartanian v. Monsanto Co., 131 F.3d 264, 268-72 (1st Cir. 1997) (summarizing approaches taken by various courts to issue of when an employer must notify employees of proposed changes in a plan).

[108] But as the victory of defendants at trial in an ERISA stock drop lawsuit demonstrates, "there is a vast difference between making conclusory allegations and proving a fiduciary violation at trial." Jackson and Weals, *supra* note 80, at 3.

[109] *See Varity*, 516 U.S. at 496 (recognizing that fiduciary duties under ERISA "draw much of their content from the common law of trusts"). Although ERISA does not explicitly incorporate all of the duties developed in the common law of trust, courts have often "import[ed] a variety of the subrules of trust administration that Congress did not spell out in the statutory text." *See generally* Langbein, *supra* note 37, at 1326-27 (noting, for example, that courts have imported "the duty to inform beneficiaries about significant aspects of trust administration; the duties to collect, segregate and earmark, and protect trust property; and the duties to enforce and defend claims").

[110] *See* Leckey v. Stefano, 501 F.3d 212, 224 (3d Cir. 2007) ("Ordinarily a trustee does not commit a breach of trust if he does not intentionally or negligently do what he ought not to do or fail to do what he ought to do. In other words, he does not commit a breach of trust unless he is personally at fault.") (citing RESTATEMENT (SECOND) OF TRUSTS § 201 cmts. a-c (1959)).

[111] The term "loss" in section 409 is not defined in ERISA. One court has suggested in this regard: "The Act's legislative history, however, indicates that Congress' intent was 'to provide the full range of legal and equitable remedies available in both state and federal courts.'" Donovan v. Bierwirth, 754 F.2d 1049, 1052 (2d Cir. 1985) (citing H. Rep. No. 533, 93d Cong., 2d Sess., reprinted in 1974-3 U.S. Code Cong. & Ad. News 4639, 4655).

[112] *See* Haddock v. Nationwide Fin. Servs., 570 F. Supp. 2d 355, 366 (D. Conn. 2008) ("It is not sufficient, however, to state a claim by conjecturing that 'to the extent' there was harm to the Plans, the Trustees are liable. Put simply, to survive a motion to dismiss, a plausible claim for breach of fiduciary duty must allege some type of actual harm or loss to the Plans.").

[113] *See* LaRue v. DeWolff, Boberg & Assocs., 552 U.S. 248, 256 (2008).

[114] *See, e.g.*, Donovan v. Bierwirth, 754 F.2d 1049, 1056 (2d Cir. 1985) (comparing how much a plan earned from an imprudent investment to how much it would have earned had the funds been available for other purposes), 1058 (discussing factors affecting calculation of loss, including, for example, the choice of starting and ending dates of the comparison period, as well as market conditions and abnormalities affecting the price of the improperly purchased stock); *see also* In re Boston Sci. Corp. ERISA Litig., 254 F.R.D. 24, 31 (D. Mass. 2008) ("[P]articipants can only recover if they can show that the value of the investments would have been greater had the fiduciary fulfilled its duty."); RESTATEMENT (SECOND) OF TRUSTS § 205(b) (1959) (requiring a trustee who commits a breach of trust to restore the trust to the value that it would have had if no breach of trust had been committed).

[115] *See Donovan*, 754 F.2d at 1052 n.3.

[116] *See, e.g.*, Willett v. Blue Cross & Blue Shield, 953 F.2d 1335, 1343 (11th Cir. 1992); Friend v. Sanwa Bank Cal., 35 F.3d 466, 469 (9th Cir. 1994) (citing Brandt v. Grounds, 687 F.2d 895, 898 (7th Cir. 1982)).

[117] *See* RESTATEMENT (SECOND) OF TRUSTS § 205 cmt. f (1959) ("If the trustee commits a breach of trust and if a loss is incurred, the trustee may not be chargeable with the amount of the loss if it would have occurred in the absence of a breach of trust.").

[118] *See generally* Chao v. Trust Fund Advisors, No. 02-559, 2004 U.S. Dist. LEXIS 4026, at *17-18 (D.D.C. Jan. 20, 2004) (discussing approaches taken by different courts to the issue).

[119] *See* Roth v. Sawyer-Cleator Lumber Co., 16 F.3d 915, 920 (8th Cir. 1994).

[120] *See* Silverman v. Mut. Benefit Life Ins. Co., 138 F.3d 98, 104 (2d Cir. 1998); *Willett*, 953 F.2d at 1343.

[121] *See* ERISA § 404(c) (codified at 29 U.S.C. § 1104(c) (2006)).

[122] 29 C.F.R. § 2550.404c-1 (2009) requires, among other things, that participants in a 404(c) plan have the opportunity to invest in a "broad range of investment alternatives" and receive information about participant transactions and associated fees and about investments in employer stock. Participants are also entitled, upon request, to receive other information about available investment alternatives, including prospectuses, financial statements, annual reports, and expense information.

[123] *See, e.g.,* Spano v. Boeing Co., No. 06 Civ. 743, 2007 WL 1149192 (S.D. Ill. Apr. 18, 2007) (court finds that section 404(c) is an affirmative defense and not a viable ground for termination of the lawsuit on a motion to dismiss).

[124] *See* ERISA §§ 101-102 (codified at 29 U.S.C. §§ 1101-1102 (2006)); 29 C.F.R. § 2520.102-3 (2009).

[125] *See* ERISA § 103 (codified at 29 U.S.C. § 1103 (2006)).

[126] On November 16, 2007, the DOL's Employee Benefits Security Administration published final form revisions and a final regulation providing new requirements. *See* DOL, Annual Reporting and Disclosure, 72 Fed. Reg. 64,710 (Nov. 16, 2007); DOL, Revision of Annual Information Return/Reports, 72 Fed. Reg. 64,731 (Nov. 16, 2007). As revised, Schedule C of Form 5500, which plan administrators file with the DOL (and the IRS), requires increased disclosure of service provider fees and other compensation. These revisions are generally effective for plan years beginning on or after January 1, 2009, with the first filings to be made on the revised form in 2010.

[127] *See* 29 C.F.R. § 2520.102-3(t)(2) (2009).

[128] *See* 29 C.F.R. § 2550.404c-1 (2009).

[129] *See* DOL, Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg 43,014 (proposed July 23, 2008).

[130] *See* Curtiss-Wright Corp. v. Schoonejongen, 514 U.S. 73, 83 (1995).

[131] *See, e.g.*, Board of Trs. of CWA/ITU Negotiated Pension Plan v. Weinstein, 107 F.3d 139, 147 (2d Cir. 1997) ("[It] is inappropriate to infer an unlimited disclosure obligation on the basis of general provisions [in ERISA] that say nothing about disclosure."); In re Citigroup ERISA Litig., No. 07 Civ. 9790, 2009 U.S. Dist. LEXIS 78055, at *65 (S.D.N.Y. Aug. 31, 2009).

[132] *See* Ehlmann v. Kaiser Found. Health Plan of Tex., 198 F. 3d 552 (5th Cir. 2000) (plan fiduciaries not required to disclose physician compensation or reimbursement plans); Board of Trs. of CWA/ITU Negotiated Pension Plan v. Weinstein, 107 F. 3d 139 (2d Cir. 1997) (plan fiduciaries not required to disclose actuarial valuation reports); Faircloth v. Lundy Packing Co., 91 F.3d 648 (4th Cir. 1996) (plan fiduciaries not required to provide plan's fidelity bond, appraisal reports regarding plan sponsor's financial status and operations, or IRS determination letter showing that the plan was tax-qualified). *See also* Hecker v. Deere & Co., 496 F. Supp. 2d 967, 974 (W.D. Wis. 2007) ("Where as here Congress has by statute and related regulation, created detailed rules governing disclosure requirements, it would be inappropriate to ignore and augment them using the general power to define fiduciary obligations.").

[133] *See, e.g.*, Varity Corp. v. Howe, 516 U.S. 489, 506 (1996) ("[L]ying is inconsistent with the duty of loyalty owed by all fiduciaries and codified in [ERISA]"); Edgar v. Avaya, Inc., 503 F.3d 340, 350 (3d Cir. 2007); *Citigroup*, 2009 U.S. Dist. LEXIS 78055, at *62 (quoted in text) (emphasis in original).

[134] *See Varity*, 516 U.S. at 507.

[135] *Compare* Bins v. Exxon Co. U.S.A., 220 F.3d 1042, 1045 (9th Cir. 2000) (holding that "[i]n the absence of an employee inquiry … the employer-fiduciary does not have an affirmative duty to volunteer information about any changes prior to their final adoption") *with* Hecker v. Deere, 556 F.3d 575, 585 (7th Cir. 2009) (citing a Seventh Circuit decision before *Varity* for the proposition that a fiduciary may breach its duty through a "material omission"), *cert. denied* 175 L. Ed. 973 (2010). *See generally* Joseph E. Czerniawski, Comment, Bins v. Exxon*: Affirmative Duties to Disclose Proposed Benefit Changes in the Absence of Employee Inquiry*, 76 NOTRE DAME L. REV. 783 (2001).

[136] *See, e.g.*, Bixler v. Cent. Penn. Teamsters Health & Welfare Fund, 12 F.3d 1292, 1300 (3d Cir. 1993); Krohn v. Huron Mem. Hosp., 173 F.3d 542, 548 (6th Cir. 1999).

[137] *See* In re Citigroup ERISA Litig., No. 07 Civ. 9790, 2009 U.S. Dist. LEXIS 78055, at *68 (S.D.N.Y. Aug. 31, 2009) (noting that to require such disclosure by fiduciaries "would transform fiduciaries into investment advisors, and … fiduciaries do 'not have a duty to 'give investment advice' or 'to opine on' the stock's condition.'") (citation omitted).

[138] *See* Murphy et al., *supra* note 78.

[139] *See id.*; *Hecker*, 556 F.3d at 578, 584-86. It is worth noting that the term "revenue sharing" as used here does not have the same meaning as in the securities law context. *See* Murphy et al., *supra* note 78, at 187 ("While revenue sharing traditionally refers to an arrangement pursuant to which a mutual fund family agrees to pay a broker/dealer a fee in return for certain marketing benefits, in the context of retirement plans, revenue sharing generally refers to investment managers 'sharing' asset-based revenues with administrative service providers that provide services directly to retirement plans.").

[140] ERISA permits a plan fiduciary to arrange for a party in interest to provide "services necessary for the establishment or operation of the plan," provided that both the arrangement and the compensation for such services are "reasonable." *See* ERISA § 408(b)(2) (codified at 29 U.S.C. § 1108(b)(2) (2006)); 29 C.F.R. § 2550.408b-2(a) (2009). As described above, *see* Reasonable Contract Release, *supra* note 31, at 70,991, in 2007, the DOL proposed regulations under section 408(b)(2) that would require service providers to provide certain disclosure about compensation, services, and potential conflicts of interest.

[141] Notwithstanding this fact, over the past decade the plaintiffs' bar has frequently used class actions under the Securities Act of 1933, formally couched in terms of disclosure, to wage thinly veiled attacks on management of funds. The plaintiffs' bar has also sought, in some cases, to frame mismanagement claims as securities fraud actions under the Securities Exchange Act of 1934. *See generally* ICI MUT. INS. CO., MUTUAL FUND PROSPECTUS LIABILITY: UNDERSTANDING AND MANAGING THE RISK 6-14 (2010).

[142] *See* Matta, *supra* note 15, at 9-10. In a somewhat different formulation, *The Restatement (Third) of Trusts* suggests that ERISA "has been interpreted to create not a standard of a 'prudent expert' but one of prudence fitting the particular trust." § 227 general notes (2007). Regardless of the formulation, ERISA appears to hold plan fiduciaries to a higher standard than a mere "prudent *man*" standard.

[143] *See* ERISA § 404(a)(1)(c) (codified at 29 U.S.C. § 1104(a)(1)(C) (2006)).

[144] *See* Calif. Ironworkers Field Pension Tr. v. Loomis Sayles & Co., 259 F.3d 1036, 1043 (9th Cir. 2001); Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th Cir. 1983).

[145] *See Loomis Sayles*, 259 F.3d at 1044 (affirming lower court's ruling that ERISA fiduciary adequately investigated use of inverse floaters, where the financial analysis system used by the fiduciary "was the tool prevalently used in the industry").

[146] *See* 29 C.F.R. § 2550.404a-1 (2009).

[147] *See generally* ERISA § 407 (codified at 29 U.S.C. § 1107 (2006)).

[148] *See, e.g.*, In re Unisys Sav. Plan Litig., 74 F.3d 420, 438 (3d Cir. 1996).

[149] *Id.* (citing factors described in the legislative history of ERISA set forth in H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038, 5085); *see also* RESTATEMENT (SECOND) OF TRUSTS, § 228 cmt. a (1959).

[150] *See Unisys*, 74 F.3d at 438 ("ERISA's legislative history, however, indicates that a fiduciary's performance of the duty may be measured by the diversity it has achieved in a particular investment vehicle and, where the management of a plan's investments is distributed among several managers, in the segment of the plan for which it has responsibility."). *But see* Farm King Supply, Inc. Integrated Profit Sharing Plan & Trust v. Edward D. Jones & Co., 884 F.2d 288, 294 (7th Cir 1989) (suggesting that a person who provides "individualized investment advice regarding 'investment policies or strategy, overall portfolio composition, or diversification of plan investments'" (citing 29 C.F.R. § 2510.3-21(c)(1)(ii)(B) (2009)) should have knowledge of the entire composition of the plan's portfolio).

151 *But see* 15 U.S.C. § 80a-35(b) (2006) (codifying section 36(b) of the Investment Company Act of 1940) (permitting a fund shareholder to sue an investment adviser for breach of fiduciary duty with respect to the adviser's receipt of fees).

152 *Compare, e.g.*, Hecker v. Deere & Co., No. 06 Civ. 719 (W.D. Wis. June 21, 2007) (granting motion to dismiss) *with* Kennedy v. ABB, Inc., No. 06 Civ. 4305 (W.D. Mo. Feb. 11, 2008) (denying motion to dismiss); Phones Plus, Inc. v. Hartford Fin. Servs. Group, Inc., No. 06 Civ. 1835 (D. Conn. Oct. 23, 2007) (denying motion to dismiss).

153 *See, e.g.*, *Hecker* (alternative ground for dismissal).

154 *See* DOL, *Fact Sheet, Definition of Fiduciary Regulation (Investment Advice)* (2009) (noting the DOL's intention "to publish a proposed regulation in June 2010 to amend the current regulatory definition of 'fiduciary' to include more persons, such as pension consultants, as fiduciaries"), *available at* http://www.dol.gov/ebsa/regs/unifiedagenda/ebsafall2009/1210-AB32fs.html.

155 *See* ERISA § 403(a) (codified at 29 U.S.C. § 1103(a) (2006)).

156 *See* DOL, Field Assistance Bulletin 2004-03 (Dec. 17, 2004), *available at* http://www.dol.gov/ebsa/regs/fab_2004-3.html [hereinafter FAB 2004-03].

157 *See, e.g.*, Kemper v. Enron Corp., No. 01 Civ. 4089 (S.D. Tex. filed Dec. 3, 2001) (naming former directed trustee of Enron 401(k) plan as a defendant); Blyler v. Agee, No. 97 Civ. 332 (D. Idaho filed July 18, 1997) (naming directed trustees of the Morrison Knudsen ESOP and 401(k) plans, respectively, as defendants).

158 *See* Maniace v. Commerce Bank of Kan. City, 40 F.3d 264 (8th Cir. 1994); *see also* Arakelian v. Nat'l W. Life Ins. Co., 755 F. Supp. 1080, 1082 (D.D.C. 1990). By contrast, the DOL has taken the position that a directed trustee is, "by definition, always" a fiduciary (albeit one with "significantly limited" responsibilities). *See* FAB 2004-03, *supra* note 156.

159 *See* FAB 2004-03, *supra* note 156.

160 *See, e.g.*, Afridi v. Nat'l City Bank, No. 03-cv-7663, 2007 U.S. Dist. LEXIS 63356, at *19-*20 (N.D. Ohio Aug. 28, 2007) (citing FAB 2004-03, *supra* note 156, for the proposition that "a directed trustee is liable for investing pursuant to an instruction that it knew or should have known was not made 'in accordance with the terms of the plan' or that it was 'contrary to' ERISA"). *See also* Kling v. Fid. Mgmt. Trust Co., 270 F. Supp. 2d 121, 2003 (D. Mass. 2003) (denying motion to dismiss because the directed trustee "may still be found liable if a jury determines that [it] followed directions that were contrary to the Plan or ERISA"); In re Sprint Corp. ERISA Litig., 388 F. Supp. 2d 1207 (D. Kan. 2004) (noting that it is difficult to conclude at an early stage of the litigation that the fiduciary instructions followed by a directed trustee are proper and consistent with ERISA and the plan).

161 *See* ERISA § 410(a) (codified at 29 U.S.C. § 1110(a) (2006)).

162 *See* ERISA § 410(b) (codified at 29 U.S.C. § 1110(b) (2006)).

163 Broadly stated, D&O coverage is generally designed to insure against financial losses that *individuals* may sustain in claims alleging that errors or omissions were committed by them in their capacities as directors or officers. By contrast, E&O coverage (sometimes referred to as "entity" coverage) is generally designed to insure against financial losses that insured *entities* may *themselves* sustain in claims alleging that errors or omissions were committed by them (or by persons for whose errors and omissions the entity is legally responsible) in their provision of professional services.

164 *See, e.g.*, JOHN ALAN APPLEMAN, APPLEMAN ON INSURANCE 2D § 146.6 (2d ed.) ("Professional liability policies frequently exclude from coverage claims based upon [ERISA]."); Hous. & Redev. Ins. Exch. v. Lycoming County Hous. Auth., 58 Pa. D. & C.4th 321 (2001) (noting that ERISA exclusion precluded coverage for former employee's claims for violations of the Comprehensive Omnibus Budget Reconciliation Act of 1985, which amended ERISA), *aff'd*, 809 A.2d 1096 (Pa. Commw. Ct. 2002).

[165] Even if fiduciary liability coverage is not expressly provided, D&O/E&O policy forms may nevertheless be viewed as including some degree of fiduciary liability coverage, depending on the wording of the policy form and on whether the form includes an express ERISA exclusion. Thus, for example, D&O/E&O policies may provide explicit coverage for "breach of duty," a term which has been interpreted by some courts as encompassing breach of *fiduciary* duty. *See, e.g.*, Citizens First Nat'l Bank of Princeton v. Cin. Ins. Co., 200 F.3d 1102 (7th Cir. 2000) (construing the policy definition of "Wrongful Act," which included, inter alia, breach of duty, as encompassing a breach of fiduciary duty).

[166] *See* ERISA § 412 (codified at 29 U.S.C. § 1112 (2006)). Section 412 of ERISA provides some exemptions from these fidelity bond requirements. For example, a bank or insurance company (or director, officer, or employee thereof) that satisfies certain criteria is not required to be bonded. A broker-dealer (or a director, officer, or employee of such broker-dealer) that is subject to the fidelity bond requirements of a "self-regulatory organization" (as defined in section 3(a)(26) of the Securities Exchange Act of 1934 (codified at 15 U.S.C. 78c(a)(26) (2006))) is also not required to be bonded. In addition to the statutory exemptions, the DOL has provided exemptions to certain other institutions (e.g., various banking institutions and trust companies that are not exempted by the statute).

[167] In its guidance on ERISA fidelity bonds, the DOL has advised that fraud and dishonesty include, among other things, larceny, theft, embezzlement, misappropriation, and forgery, and do not require that the wrongdoer have realized any personal gain from the fraud or dishonesty. *See* DOL, Field Assistance Bulletin 2008-04, at Q-1 (Nov. 25, 2008), *available at* http://www.dol.gov/ebsa/regs/fab2008-4.html.

[168] *See, e.g.*, Richard G. Clarke, *Fiduciary Liability: Obtaining Effective Insurance*, INS. J., Feb. 21, 2005, http://www.insurancejournal.com/magazines/midwest/2005/02/21/features/52285.htm.

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