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WHAT'S INSIDE

MORTGAGE-BACKED SECURITIES

New York high court dismisses legal malpractice suit over MBS advice

By Peter H. Hamner, Esq., Senior Legal Writer, Westlaw Journals

New York state's highest court has thrown out a lawsuit that accuses the law firm Cadwalader Wickersham & Taft of providing bad legal advice to Nomura affiliates about mortgage-backed securities.

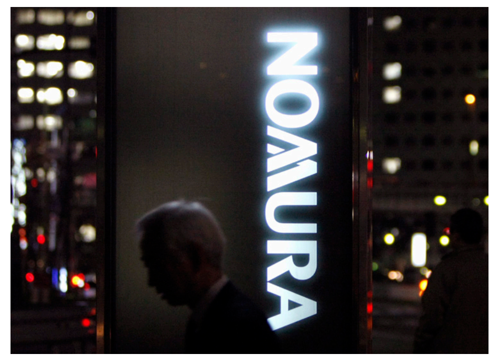
Nomura Asset Capital Corp. et al. v. Cadwalader Wickersham & Taft, No. 122, 2015 WL 6180983 (N.Y. Oct. 22, 2015).

Cadwalader adequately advised and conducted proper due diligence for Nomura Asset Capital Corp. and Asset Securitization Corp. on a failed securities offering, the New York Court of Appeals said.

Attorneys for Nomura and Cadwalader did not respond to a request for comment.

THE SECURITIZATION AT ISSUE

The case stems from a mortgage-backed securities transaction in 1997, known as Series 1997–D5.



REUTERS/Toru Hanai

The New York Court of Appeals has found that law firm Cadwalader Wickersham & Taft adequately advised and conducted proper due diligence for Nomura Asset Capital Corp. and Asset Securitization Corp. on a failed securities offering.

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No sign any jurisdictional 'battle' looms on dividend index futures

By Mark D. Young, Esq., Prashina Gagoomal, Esq., and Graham McCall, Esq.
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In mid-November, the Chicago Mercantile Exchange will make available for trading a recently approved futures contract called the Index Contract on the S&P 500 Dividend Index.[1]

The CME is promoting the Index Contract as an "innovative new way to express views on S&P 500 dividend exposure."

The Commodity Futures Trading Commission issued an approval order for the Index Contract on July 22, finding the Dividend Index to be an excluded commodity under the Commodity Exchange Act. As a result, it deemed the Index Contract a futures contract on an excluded commodity subject to the CFTC's exclusive jurisdiction.[2]

As described in the CFTC's approval order, the Dividend Index underlying the Index Contract:

> represents the accrued ex-dividend amounts associated with all the constituent companies of the S&P 500 cumulated over the course of a specified quarterly accrual period. The [Dividend] Index … at any given point represents a running total of dividends, through their ex-dividend dates, associated with all stocks in the S&P 500. It is calculated through a bottom-up approach whereby a running total of the dividends paid by S&P 500 constituent companies during the quarter is continuously calculated.[3]

A recent article by Morgan Lewis attorneys predicts a "jurisdictional battle" between the CFTC and the Securities and Exchange Commission over the Index Contract.[4]

The article questions the CFTC's characterization of the Index Contract, pointing to a comment letter filed by SEC staff. It says the letter raised "'substantial' legal and policy concerns over whether the [Index Contract] should be instead categorized as a security future subject to the joint jurisdiction of both agencies."[5]

The article further said market participants who transact in the Index Contract under the CFTC's jurisdictional umbrella may find themselves at risk of an SEC enforcement action for alleged violations of the federal securities laws.

But the article mischaracterizes both the nature of the jurisdictional question at issue and the implications of the CFTC's approval order, contrary to explicit statutory provisions and well-settled case law on the scope of the CFTC's exclusive jurisdiction.

> A recent article by Morgan Lewis attorneys predicts a "jurisdictional battle" between the CFTC and the SEC over the Index Contract.

For the reasons explained below, market participants should not be deterred from transacting in the Index Contract based on the article's warnings.

BACKGROUND

In its approval order, the CFTC found that "the Dividend Index is an excluded commodity (that is not a security or security index) … because it is an 'economic or commercial index based on … values or levels that are not within the control of any party to the relevant contract, agreement, or transaction,' or, in the alternative, is an 'occurrence, extent of an occurrence, or contingency … that is beyond the control of the parties to the relevant contract, agreement, or transaction and is associated with a financial, commercial, or economic consequence.'"[6]

As a result, the CFTC concluded, "pursuant to CEA section 2(a)(1)(A), the CFTC has *exclusive jurisdiction* over the Index Contract."[7]

IMPLICATIONS OF CFTC EXCLUSIVE JURISDICTION

More than 40 years ago, Congress vested the CFTC with exclusive jurisdiction over transactions involving futures contracts. The principle of exclusive jurisdiction has become a bedrock of CEA jurisprudence ever since.



Mark D. Young (L) is co-head of the derivatives group at **Skadden, Arps, Slate, Meagher & Flom** in Washington and a former assistant general counsel of the Commodity Futures Trading Commission. His practice focuses on financial services regulation, derivatives and agency litigation, legislative advocacy, and business and transactional counseling. In the derivatives litigation area, he has successfully argued appeals in landmark cases involving jurisdiction and product characterization issues under the federal securities laws and the Commodity Exchange Act. **Prashina Gagoomal** (C) is an associate in Skadden's New York office, where she focuses her practice on derivatives regulatory counseling and litigation strategy advice. She has drafted numerous comment letters on Dodd-Frank rulemakings proposed by the CFTC and Securities and Exchange Commission, filed appeals before the CFTC and briefs in federal and state court, and participated in legislative advocacy efforts to further clients' interests. **Graham McCall** (R) is an associate in Skadden's Washington office. He counsels financial institutions, exchange operators, private funds, energy companies and other end users on a wide range of regulatory, legislative, and enforcement matters involving the CEA. Prior to joining Skadden, he was an attorney-adviser at the CFTC in the Division of Market Oversight, Office of Chief Counsel, where he worked on several Dodd-Frank rulemakings and new product jurisdictional disputes.

Courts have routinely recognized that "CEA Section 2(a)(1)(A) vests the CFTC with jurisdiction to the exclusion of other agencies" in order to achieve "Congress' very clear goal of centralizing oversight of futures contracts."[8]

In the past, and most often near the CFTC's inception, the SEC contested CFTC exclusive jurisdiction in various ways.

The courts, and particularly the 7th U.S. Circuit Court of Appeals, uniformly sided with the CFTC in resolving these disputes.[9]

Court decisions have made it clear that, where the CFTC has exclusive jurisdiction, it "serves to strip [other agencies] of standing to bring [a] suit."[10]

The Morgan Lewis article ignores the consequences of this well-established precedent.

However, the CFTC found that the Index Contract falls under its exclusive jurisdiction as a futures contract on an excluded commodity that is not a security or security index.

In either case, CFTC exclusive jurisdiction is the end result — one that SEC staff itself was amenable to — leaving the SEC with no jurisdiction to pursue claims against market participants transacting in the Index Contract.

To the extent any residual concern over regulatory uncertainty stemming from the CFTC's approval order exists, market participants should bear in mind historical precedent involving principles of administrative comity.

Several years ago, a reverse situation existed. Lacking the CFTC's "concurrence," the SEC in 2009 approved the Chicago Board Options Exchange's petition to list an option on the Dividend Index, the Index Option.

> Court decisions have made it clear that, where the CFTC has exclusive jurisdiction, it "serves to strip [other agencies] of standing to bring [a] suit."

It concedes that the CFTC's approval order and its determination of CFTC exclusive jurisdiction "exclude the SEC from having the oversight role over the Dividend Index that it would otherwise have if the Index Contract was considered a security future."[11]

Yet in the same breath, it recites a litany of potential charges that the SEC could bring against market participants transacting in the Index Contract.[12]

It fails to connect the dots as follows: If the SEC is ousted from an "oversight role" over the Index Contract because of CFTC exclusive jurisdiction, then the SEC cannot claim jurisdiction to sue market participants who are transacting in the CFTC-approved Index Contract.

Notably, the article overlooks a second basis for CFTC exclusive jurisdiction, one recognized by the very SEC staff comment letter the article refers to as foreshadowing a jurisdictional battle.

The SEC staff comment letter acknowledged that the Index Contract would fall under CFTC exclusive jurisdiction if based on a *broad-based* security index. Indeed, it expressed a willingness to accept this jurisdictional outcome.[13]

The CFTC staff took the same view then that the CFTC has taken now in approving the Index Contract—that is, the Dividend Index "may be more akin to an event contract rather than a securities index."[14]

Nevertheless, the SEC dismissed the CFTC view in passing and approved the Index Option as an option on a security index.[15]

However, since the SEC's approval of the Index Option in 2009, the CFTC has not challenged the SEC or any market participant on the basis that the Index Option is actually an option on an excluded commodity and hence subject to CFTC exclusive jurisdiction.[16]

Rather, the two agencies have peacefully co-existed notwithstanding their differing views on product characterization.

The Morgan Lewis article offers no credible basis for suggesting that the agencies would want to engage in a jurisdictional skirmish now over the Index Contract.

The CFTC regulates futures on the Dividend Index, and the SEC regulates options on the Dividend Index. There is no need to disturb this peace and no reason to think either agency will want to break it.

CONCLUSION

The Morgan Lewis article would have market participants believe they face great regulatory uncertainty by transacting in the Index Contract.

This belief is unfounded given the CFTC's exclusive jurisdiction and the case law precedent the article ignores.

Market participants should rest assured that as long as the CFTC's approval order claiming exclusive jurisdiction over the Index Contract is in effect, the SEC is without recourse. WJ

NOTES

1 *See* News Release, CME Group, CME Group Announces the Launch of S&P 500 Dividend Index Futures (Oct, 16, 2015), http://cmegroup.mediaroom.com/index.php?s=43&item=3668.

2 *See* Commodity Futures Trading Comm'n, Order Approving the Listing of the Chicago Mercantile Exchange's S&P 500 Dividend Index Futures Contract (2015), http://www.cftc.gov/groups/public/@otherif/documents/ifdocs/ProdCMEApprovalOrdrDividx_1507.pdf.

3 *Id.* at 1-2.

4 *See* Michael M. Philipp & Ignacio A. Sandoval, *CFTC/SEC jurisdictional battle heats up over dividend indices*, 21 Westlaw J. Derivatives 21 (Sept. 10, 2015).

5 *Id.*, citing Sec. & Exch. Comm'n, Comment Letter on Chicago Mercantile Exchange Inc. Submission of Standard and Poor's 500 Dividend Index Futures for Commission Review and Approval per Section 5c(c) of the Commodity Exchange Act and Regulation §40.3 (CME Submission No. 10-195) (July 2, 2015), http://www.cftc.gov/groups/public/@otherif/documents/ifdocs/ProdCMECommentLetter_150702.pdf.

6 *See* CFTC Approval Order, *supra* note 2, at 2-3 (quoting the definition of "excluded commodity" in Commodity Exchange Act Section 1a(19)).

7 *Id.* at 3 (emphasis added).

8 *See Hunter v. FERC*, 711 F.3d 155, 158-59 (D.C. Cir. 2013) (barring the Federal Energy Regulatory Commission from bringing an enforcement action against traders for a manipulative scheme that involved futures contracts subject to the exclusive jurisdiction of the CFTC).

9 *See Chicago Mercantile Exch. et al. v. SEC*, 883 F.2d 537 (7th Cir. 1989) (holding that the SEC lacked jurisdiction to approve the listing of "index participation" contracts which were futures contracts subject to CFTC exclusive jurisdiction); *Bd. of Trade of the City of Chicago v. SEC*, 677 F.2d 1137 (7th Cir. 1982) (holding that the SEC lacked jurisdiction to approve rule changes that would have allowed a national securities exchange to list certain government mortgage association-backed option contracts that were subject to CFTC exclusive jurisdiction),

vacated as moot, 459 U.S. 1026 (1982); *see also Bd. of Trade of the City of Chicago v. SEC*, 187 F.3d 713, 716 (7th Cir. 1999) (holding that the SEC could not unilaterally impose its view of the narrow-based nature of an index underlying a futures contract when "[r]egulation of the trading process [for such futures contract] belongs exclusively to the CFTC.").

[10] *See SEC v. Univest*, 405 F. Supp. 1057, 1058 (N.D. Ill. 1976) (holding that the SEC could not bring claims against private parties for trading options on futures contracts after the Commodity Futures Trading Commission Act of 1974 vested the CFTC with exclusive jurisdiction over such contracts).

[11] *See* Philipp & Sandoval, *supra* note 4, at 3.

[12] These violations are alleged to potentially include violations of: Securities Exchange Act of 1934 (Exchange Act) section 6(h)(1) for counter-parties transacting in a security futures product off of a registered (or notice registered) securities exchange; Exchange Act section 6(h)(2) for CME listing a security futures product that does not conform to listing standards approved by the SEC; Securities Act section 5 for counterparties transacting in an un-registered security that does not qualify for any exemption; and the broker-dealer registration requirement for unregistered futures commission merchants clearing a security futures product. *See* Philipp & Sandoval, *supra* note 4, at 4-5.

[13] *See* SEC Staff Letter, *supra* note 5, at 5.

[14] *See* Email from Julian Hammer, Assistant Gen. Counsel, CFTC to Elizabeth King, Assoc. Dir. and James L. Eastman, Chief Counsel and Assoc. Dir., Div. of Trading and Markets, Sec. & Exch. Comm'n (May 4, 2009, 17:11), http://www.sec.gov/comments/sr-cboe-2009-022/cboe2009022-1.pdf.

[15] *See* Exchange Act Release No. 61136, 74 Fed. Reg. 66713 (Dec. 16, 2009). The SEC did not characterize the nature of the underlying security index as narrow- or broad-based perhaps because, either way, the SEC has jurisdiction over all options on securities or security indices. *See* 7 U.S.C. § 2(a)(1)(C)(i)(I).

[16] As a result of the CFTC's approval order, the Dividend Index is treated as an excluded commodity that is not a security or security index for purposes of the Index Contract, while the same Dividend Index is treated as a security index for purposes of the Index Option. This difference in treatment produces an interesting result, but not because it is unprecedented for the CFTC to regulate futures on a security index while the SEC regulates options on the same index. Rather, under the analysis in the CFTC's approval order, CBOE's Index Options should be considered commodity options (*i.e.,* swaps) under the Dodd-Frank Act and subject to the CFTC's exclusive jurisdiction. *See* CEA §§ 1a(47)(A)(i); 2(a)(1)(A).

NEWS IN BRIEF

U.S. FDIC VOTES TO ADOPT FINAL MARGIN RULES FOR UNCLEARED SWAPS

(Reuters) – The U.S. Federal Deposit Insurance Corp on Oct. 22 voted to adopt long-awaited rules requiring big U.S. banks to post more collateral when they trade in riskier derivatives. The final rules were adjusted from a 2014 proposal to ease requirements for trades between swap dealers and affiliates and to exempt some types of swaps users. (*Reporting by Emily Stephenson; editing by Will Dunham*)

PIMCO LATEST TO SUE BRAZIL'S STATE-RUN OIL COMPANY

Pacific Investment Management Co. has sued Petróleo Brasileiro SA over allegations the company misled investors about the corruption scandal that has cost the company billions of dollars. The complaint, PIMCO filed by in the U.S. District Court for the Southern District of New York on behalf of several of its funds that invested in Petrobras, repeats allegations made in similar lawsuits against the oil giant. According to PIMCO's suit, Brazilian prosecutors allege Petrobras' contractors colluded with company executives and politicians to inflate bids and launder money. But Petrobras downplayed the corruption scandal in regulatory filings and reports, thereby artificially inflating its stock price in violation of federal securities laws, the suit says. When the full scale of the oil company's scheme emerged, the stock price dropped "materially," the suit says. PIMCO is seeking unspecified damages, interest and litigation costs.

PIMCO Funds et al. v. Petróleo Brasileiro SA et al., No. 15-CV-8192, complaint filed (S.D.N.Y. Oct. 16, 2015).

Related Court Document:
Complaint: 2015 WL 6388115

SEC PUBLISHES STATISTICS REPORT ON PRIVATE FUNDS

The Securities and Exchange Commission published a report Oct. 16 that provides private fund industry statistics and trends the agency aggregated from private fund advisers for the first quarter of 2013 through the fourth quarter of 2014. SEC Chief Mary Jo White said the report will help investors evaluate private funds and help the agency analyze the private funds industry. Private funds, which are not open to the public, typically are hedge funds and private equity firms. The agency collected the data from Form ADV and Form PF submissions. Investment advisers register with the SEC and state regulators using Form ADV, which includes information about the investment advisers' business and organization structure. Form PF is a reporting requirement for private fund advisers with at least $150 million assets under management. It includes general information about the types of funds advised and types of investments. The report is available at http://1.usa.gov/1MINnP5.

An analysis of the SEC's new whistleblower interpretive rule

By H. David Kotz
Berkeley Research Group

In August, the Securities and Exchange Commission issued an interpretive rule attempting to ensure that its whistleblower program provides the proper incentives for employees to file complaints with their employers without fear of retaliation.[1]

The rule clarifies that for purposes of the Dodd-Frank Wall Street Reform and Consumer Protection Act's employment retaliation protections, individuals who have not reported alleged misconduct to the SEC may nevertheless qualify as "whistleblowers."

The SEC announced that employees who report whistleblower-type complaints only to their company will still receive protection from employer retaliation.

The rule is intended to avoid a two-tiered structure of employment retaliation protection that might discourage individuals from first reporting internally in appropriate circumstances — and thus jeopardize the investor-protection and law-enforcement benefits that internal reporting can provide.

The SEC declared that under its interpretation of Dodd-Frank, an individual who reports internally and suffers employment retaliation should receive the same protection as an individual who comes forward to the SEC immediately.

The agency says that providing equivalent employment retaliation protection in both situations removes a potentially serious disincentive to internal reporting.

The SEC indicated that a contrary interpretation would undermine other incentives to encourage internal reporting that were put in place by its whistleblower rules.

While the agency has attempted to clarify its position, it is not so clear that its interpretation will be upheld.

BACKGROUND

It is instructive to consider the background of the regulator's revamped whistleblower program when analyzing these latest developments.

In early 2010, I was serving as the SEC's inspector general. We conducted an audit of the SEC's whistleblower program in place at the time.

The audit also found that the whistleblower program was not widely known — either inside or outside the SEC.[2]

We forwarded our audit findings to congressional officials. Congress signed Dodd-Frank into law July 21, 2010, mandating that the SEC revamp its whistleblower program.

The new legislation also expressly prohibited retaliation by employers against whistleblowers, and it provided whistleblowers with a private cause of action in the event that they were discharged or discriminated against by their employers in violation of the statute.

> The SEC announced that employees who report whistleblower-type complaints only to their company will still receive protection from employer retaliation.

Congress was concerned with whistleblower issues and the SEC's management of its whistleblower program. This concern derived primarily from the agency's failure to effectively heed the warnings of Harry Markopolos, who had attempted to blow the whistle on Bernie Madoff's $50 billion Ponzi scheme.

My office found during the audit that although the SEC had a bounty/whistleblower program in place for more than 20 years, very few payments had been made to whistleblowers. In fact, the SEC did not receive many applications from individuals seeking a bounty over this 20-year period.

This provision was considered crucial to encourage whistleblowers to come forward more often, both internally and to the SEC, and to remedy the deficiencies of the SEC whistleblower program.

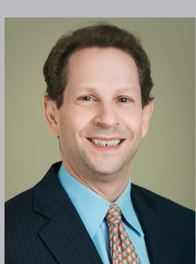
The SEC adopted rules to implement its new whistleblower program May 25, 2011.

Industry representatives recommended that the agency require employees to raise their whistleblower concerns internally before filing with the SEC, while whistleblower advocates suggested that there be no impediments to filing whistleblower claims.

Companies argued that it was only fair to allow them to fix problems internally before the government got involved, particularly if they were not aware of the problems before an internal report was filed.

Meanwhile, whistleblowers asserted that requiring employees to report internally would keep complaints from moving forward because of the fear of retaliation.

The SEC adopted a compromise position. While there is no mandatory requirement that whistleblowers report internally, the SEC



H. David Kotz is a managing director at **Berkeley Research Group**, a leading global expert services and consulting firm, where he focuses on internal investigations and serves as an expert witness in securities and fraud-related litigation. Kotz recently completed "Financial Regulation and Compliance: How to Manage Competing and Overlapping Regulatory Oversight," published by John Wiley & Sons in July. The book provides "one-stop shopping" for compliance professionals to manage the regulatory process. It includes specific hands-on advice from Kotz and expert industry leaders on regulatory and compliance-related topics, such as how to manage whistleblower complaints.

rules established incentives to encourage whistleblowers to report internally.

For example, a whistleblower could be entitled to an increased award as a direct result of their participation in internal reporting.

If a company failed to perform an investigation and report to the SEC within 120 days — and the whistleblower went to the SEC — the whistleblower could receive retroactive credit back to the original date of internal reporting, resulting in significant monetary value to the whistleblower.

> Due to ambiguity in Dodd-Frank's statutory language, the SEC rules set forth two separate definitions of the term "whistleblower": one for the bounty provision and another for the anti-retaliation provision.

THE SEC'S 2 DEFINITIONS OF 'WHISTLEBLOWER'

Under the compromise position that the SEC adopted, it was critical that whistleblowers were protected from retaliation when they attempted to take advantage of the incentives of reporting internally. However, this protection was placed in doubt almost immediately.

Due to ambiguity in Dodd-Frank's statutory language, the SEC rules set forth two separate definitions of the term "whistleblower": one for the bounty provision and another for the anti-retaliation provision.

The first definition provides that an individual was a whistleblower if, alone or jointly with others, he provided the SEC with information pursuant to the procedures set forth in the rule.[3]

The second definition provides that for purposes of the anti-retaliation protections, an individual was a whistleblower if he or she provided that information in a manner described in the statute.[4]

Under the anti-retaliation provisions and the second definition, the whistleblower is not required to bring his or her complaint to the SEC.

THE COURTS' INTERPRETATIONS

Courts have struggled to interpret these two definitions of "whistleblower" under Dodd-Frank and the SEC rules.

In July 2013 the 5th U.S. Circuit Court of Appeals, in *Asadi v. GE Energy (USA) LLC*, 720 F.3d 620, upheld the first definition of whistleblower as applicable in all circumstances. It also held that Dodd-Frank requires whistleblowers to report an alleged violation to the SEC in order to be covered by Dodd-Frank's anti-retaliation provision.

Khaled Asadi filed a complaint in the U.S. District Court for Southern District of Texas. He alleged that GE Energy violated Dodd-Frank's whistleblower-protection provision by terminating him following his internal reports of a potential Foreign Corrupt Practices Act violation.

GE Energy moved to dismiss Asadi's complaint on the basis that he did not qualify as a "whistleblower" under the whistleblower-protection provision because he only reported internally.

The 5th Circuit affirmed the District Court's dismissal of the action, rejecting the argument that the whistleblower provision should be construed to protect individuals who take actions to inform the company of their claims even if they do not provide information to the SEC.

It also found that Asadi did not meet the second definition set forth in the SEC's 2011 rule, which defines whistleblowers to include those who make internal disclosures — regardless of whether those disclosures are also made to the SEC.

Some district courts have followed *Asadi*, while others have not. In *Berman v. Neo@ Ogilvy LLC*, 801 F.3d 145 (2015), the 2nd U.S. Circuit Court of Appeals ruled that an employee who reports an alleged securities violation only to his employer is covered by Dodd-Frank's anti-retaliation provisions.

Daniel Berman had alleged in his suit in the U.S. District Court for the Southern District of New York that his employer and its parent company violated the whistleblower provisions of Dodd-Frank. Specifically, he accused the employer and its parent of wrongfully terminating him for raising concerns internally about business practices that he believed constituted accounting fraud.

The companies moved to dismiss the claim, arguing that Berman was not a whistleblower under Dodd-Frank because he did not report the alleged violations to the SEC.

The District Court agreed and granted the motion.[5]

In a 2-1 ruling, the 2nd Circuit reversed the District Court's decision. Citing the two definitions, it found that Dodd-Frank's provisions are ambiguous as to whether an employee who reports an alleged violation only internally qualifies as a whistleblower.

The 2nd Circuit determined that precluding whistleblowers who report violations internally from receiving Dodd-Frank anti-retaliation protection would be bad policy and against the spirit of the law and SEC rules. The panel deferred to the SEC's interpretation of the statute, acknowledging the SEC's August interpretive rule.

THE FUTURE IMPACT OF THE SEC'S RULE

In light of the August SEC interpretive rule and the 2nd Circuit's decision in *Berman*, some may conclude that the matter is now resolved and that the reasoning behind the *Asadi* decision is no longer tenable.

> Courts have struggled to interpret these two definitions of "whistleblower" under Dodd-Frank and the SEC rules.

But it remains unclear whether other courts will similarly defer to the SEC's interpretive rule.

In fact, the *Asadi* and *Berman* decisions have created a federal circuit split that could eventually cause the issue to end up before the U.S. Supreme Court.

In the meantime, employers must assume that courts will defer to the SEC's interpretation. They must take steps to ensure that any adverse personnel actions taken against employees who have reported alleged misconduct internally are not considered unlawful retaliation, regardless of whether the employee has also reported the alleged misconduct to the SEC.

Whistleblowers, on the other hand, should feel somewhat confident in light of *Berman* and the SEC's interpretive guidance that they are protected from retaliation even if they have only reported their claims internally.

In an abundance of caution, however, employee whistleblowers may wish to consider reporting their allegations of misconduct to the SEC or exercise their rights under the anti-retaliation provisions of other statutes, such as the Sarbanes-Oxley Act of 2002.

Despite the SEC's efforts to protect whistleblowers who file only internal reports, their protection from retaliation is not yet guaranteed. It may take the U.S. Supreme Court to decide the matter for certain. WJ

NOTES

1 *See* 17 C.F.R. § 241.

2 *See* Sec. & Exch. Comm'n, Office of Inspector Gen., Report No. 474, Assessment of the SEC's Bounty Program (2010), http://www.sec.gov/about/offices/oig/reports/audits/2010/474.pdf.

3 *See* 17 C.F.R. § 240.21F-2.

4 *See* 17 C.F.R. § 240.21F-2(b)(1).

5 *Berman v. Neo@Ogilvy LLC*, 72 F. Supp. 3d 404 (S.D.N.Y. 2015).

MBS advice

CONTINUED FROM PAGE 1

To create mortgage-backed securities, investment banks like Nomura pool hundreds or thousands of mortgage loans and transfer them to a trust that then issues securities to investors. Principal and interest payments are distributed to investors with varying maturity dates, cash flows and default risks.

FEDERAL LITIGATION

U.S. District Judge Naomi Reice Buchwald granted Nomura's motion for summary judgment, holding that the bank reasonably relied on Cadwalader's advice that the property met the 80 percent test. *LaSalle Bank v. Nomura Asset Capital Corp. et al.*, No. 00-CV-8720, 2004 WL 2072501 (S.D.N.Y. Sept. 14, 2004).

> "[We] cannot ignore that Nomura chose to run its business in this way, and that Cadwalader acted upon and relied on that business model in its representation," the Court of Appeals said.

According to the appellate opinion, Cadwalader had advised Nomura that its trust qualified as a real estate mortgage investment conduit, giving the trust certain tax exemptions and qualifying it as a pass-through entity.

To qualify as a REMIC, a trust must include loans with a value-to-loan ratio of 80 percent, meaning that the value of the property is at least 80 percent of the value of the loan.

Nomura promised in a pooling and servicing agreement with LaSalle Bank, the trust's trustee, that the loans backing the trust met certain underwriting guidelines and was a qualified REMIC.

After a $50 million loan for a hospital in Chicago underlying the Series 1997–D5 defaulted in 2000, the trustee demanded that the investment bank buy back the loan, claiming it breached the agreement because it did not meet the 80 percent threshold.

Nomura refused and LaSalle sued the bank in the U.S. District Court for the Southern District of New York asserting breach of contract.

The 2nd U.S. Circuit Court of Appeals reversed the decision, remanding the case to the District Court to find out whether the property did in fact meet the 80 percent requirement. *LaSalle Bank v. Nomura Asset Capital Corp. et al.*, 424 F.3d 195 (2d Cir. 2005).

Nomura subsequently settled the suit for $67.5 million.

MALPRACTICE SUIT

The bank then sued Cadwalader in New York state court, accusing the firm of legal malpractice and failing to perform the necessary due diligence to determine whether the hospital loan met the REMIC requirements.

New York Supreme Court Justice Melvin L. Schweitzer denied Cadwalader's bid to toss the suit, citing conflicting evidence over the firm's legal advice and due diligence. *Nomura Asset Capital Corp. et al. v. Cadwalader Wickersham & Taft*, No. 116147/06, 2012 WL 1647308 (N.Y. Sup. Ct., N.Y. Cty. Jan. 11, 2012).

The New York Appellate Division, 1st Department, overturned Justice Schweitzer's decision on the legal advice claim in a 3-1 ruling. *Nomura Asset Capital Corp. et al. v. Cadwalader Wickersham & Taft LLP*, 115 A.D.3d 228 (N.Y. App. Div., 1st Dep't 2014).

The panel upheld the due diligence claim.

Both parties appealed the ruling to the Court of Appeals, which dismissed the suit in its entirety.

The law firm informed Nomura on how to meet REMIC requirements and it advised that if a loan did not meet a requirement on its face then the bank needed to investigate the loan and consult with outside counsel, the state high court ruled.

Because Cadwalader had relied on information it received from Nomura regarding the 80 percent test, the appeals court said the law firm provided adequate advice and fulfilled its due diligence responsibilities.

Nomura also did not ask or expect Cadwalader to review property appraisals to compute the 80 percent figure and this was common legal practice, the opinion says.

"[We] cannot ignore that Nomura chose to run its business in this way, and that Cadwalader acted upon and relied on that business model in its representation," the panel said. WJ

Attorneys:
Plaintiffs: James T. Potter, Hinman Straub PC Albany, N.Y.

Defendant: David R. Marriott, Cravath Swaine & Moore, New York

Related Court Document:
Opinion: 2015 WL 6180983

See Document Section A (P. 21) for the opinion.

Delaware Chancery Court judge tosses creditor's fiduciary duty suit

By Peter H. Hamner, Esq., Senior Legal Writer, Westlaw Journals

A creditor cannot continue its lawsuit accusing private equity firm Athilon Capital Corp. of breaching its fiduciary duties by acting in favor of certain noteholders over others, a Delaware state court judge has determined.

Quadrant Structured Products Co. v. Vertin et al., No. 6990–VCL, 2015 WL 6157759 (Del. Ch. Oct. 20, 2015).

Following a five-day trial in the Delaware Chancery Court, Vice Chancellor J. Travis Laster dismissed creditor Quadrant Structured Products Co.'s claims for breach of an indenture agreement, breach of fiduciary duty and fraudulent transfer.

Quadrant failed to show Athilon was insolvent and its board improperly engaged in a risky business strategy instead of liquidating the company to preserve its value, he ruled.

"The fact that a business decision runs contrary to a creditor's generic preference for greater security does not mean that the decision was made with an actual intent to hinder, delay or defraud any creditor," Vice Chancellor Laster said in his opinion.

Quadrant sued Athilon and its management in Delaware, where Athilon is incorporated, accusing the underwriter of paying interest to junior noteholders, failing to liquidate and repurchasing debt without regard to senior noteholders like Quadrant.

Junior notes are riskier investments because they are lower in priority to senior notes during liquidation and bankruptcy proceedings.

Quadrant bought senior notes Athilon issued for funding in 2004 and 2005, according to court filings. Athilon's business was underwriting credit default swaps, a kind of financial insurance policy for debt securities.

Athilon's business took a massive hit during the financial crisis, and it struggled to stay afloat.

Investment firm Merced Capital LP acquired 100 percent of Athilon's equity and put in place its own board of directors. Merced repurchased debt, failed to liquidate the company's business and began paying interest on its junior notes, the opinion said.

Quadrant filed suit in the Chancery Court, accusing Athilon of benefiting the junior noteholders like Merced in the short term but harming Quadrant and other senior noteholders.

Athilon should have liquidated the business to preserve its value for creditors, Quadrant said.

The defendant moved for summary judgment, contending Quadrant lacked standing to sue as a creditor because it did not show the underwriter was continuously insolvent during the litigation and that it had "no reasonable prospect of returning to solvency."

In May Vice Chancellor Laster rejected these arguments and refused to dismiss the suit, saying Athilon could avoid liability if Quadrant fails to demonstrate Athilon was solvent when the creditor sued, not during the course of the litigation. *Quadrant Structured Prods. Co. v. Vertin et al.*, No. 6990–VCL, 2015 WL 2062115 (Del. Ch. May 4, 2015).

The case went to trial in June, and Vice Chancellor Laster found in favor of Athilon and its board.

While the decision to pay interest and purchase riskier assets reduced Athilon's cash and increased its risk of default, the company remained solvent, the judge found.

"Unless a creditor bargains for an applicable contract right, the creditor does not have the ability to interfere with the operations of a solvent firm," Vice Chancellor Laster ruled.

"Unless a creditor bargains for an applicable contract right, the creditor does not have the ability to interfere with the operations of a solvent firm," Vice Chancellor J. Travis Laster said.

"At present, Athilon and its management plan to manage the company's business to maximize the value of the equity and take full advantage of the lenient terms provided by Athilon's creditors. Nothing about that plan involves an intent to defraud creditors," he said. WJ

Related Court Document:
Opinion: 2015 WL 6157759

See Document Section B (P. 29) for the opinion.

Australia-based funds' CDO suit will head to trial, New York judge rules

A lawsuit accusing a financial management company of fraudulently inducing two Australia-based investment funds to invest $28 million in a collateralized debt obligation must go to trial, a New York state judge has held.

Basis Pac-Rim Opportunity Fund et al. v. TCW Asset Management Co., No. 654033/2012, 2015 WL 6127082 (N.Y. Sup. Ct., N.Y. Cty. Oct. 16, 2015).

New York County Supreme Court Justice Shirley Werner Kornreich declined to find in favor of either the plaintiff funds or defendant TCW Asset Management Co., saying triable issues of fact remained.

THE CDO

According to Justice Kornreich's opinion, Basis Pac-Rim Opportunity Fund and Basis Yield Alpha Fund invested $28 million in a collateralized debt obligation called Dutch Hill Funding II Ltd. in May 2007. TCW marketed the CDO.

A CDO is a security backed by pools of other debt securities, including mortgage-backed securities, credit derivatives, other CDOs or other structured securities.

Although the housing market was in turmoil in 2007, TCW and nonparty Deutsche Bank told Pac-Rim and Alpha that the Dutch Hill CDO was backed by residential mortgage-backed securities the two identified as good investments, the opinion said.

Mortgage-backed securities are backed by pools of mortgage loans. Principal and interest payments are distributed to investors with varying maturity dates, cash flows and default risks.

Many blame the housing market crash and the risky mortgage-backed securities for the financial crisis of the late 2000s.

When the housing market bubble collapsed, the underlying mortgages defaulted en masse, causing the CDO to go sour. The credit ratings agencies downgraded the pooled mortgage-backed securities, and nonparties initiated margin calls on the Dutch Hill CDO. This activity caused the plaintiff investment funds to incur significant losses, the opinion said.

> "There are questions of fact about whether the representations [defendant] TCW made to [plaintiff] Basis about [the] Dutch Hill [CDO] were material to Basis' investment decision," Justice Shirley Werner Kornreich ruled.

LITIGATION

Pac-Rim and Alpha filed suit in New York state court, seeking damages for alleged fraud, fraudulent concealment, negligent misrepresentation, breach of contract and unjust enrichment.

The funds accused TCW of falsely claiming it could navigate the crumbling MBS market.

Justice Kornreich dismissed the negligent-misrepresentation claim in 2013 and the 1st Department Appellate Division upheld the decision earlier this year. *Basis Pac-Rim Opportunity Fund et al. v. TCW Asset Mgmt. Co.*, 124 A.D.3d 538 (N.Y. App. Div., 1st Dep't 2015).

Both parties moved for summary judgment, but Justice Kornreich rejected their attempts.

"There are questions of fact about whether the representations TCW made to Basis about Dutch Hill were material to Basis' investment decision," she ruled.

Justice Kornreich said a reasonable fact finder could come to the conclusion "that Basis believed TCW had a technique by which it could select [residential mortgage-backed securities] that did not suffer from the fraud that permeated the 2006 mortgage origination market and that Basis invested in Dutch Hill in reliance on TCW's representations." WJ

Related Court Document:
Opinion: 2015 WL 6127082

DBRS charges continue SEC's scrutiny of credit ratings agencies

By Cory Hester, Senior Content Writer, Westlaw Daily Briefing

After releasing a report earlier this year recommending various improvements for the credit ratings industry, the Securities and Exchange Commission recently settled charges against DBRS Inc. for certain securities violations related to its ratings.

In the Matter of DBRS Inc., No. 3-16922, 2015 WL 6447442 (S.E.C. Oct. 26, 2015).

The SEC issued an order on Oct. 26 alleging that DBRS misrepresented its surveillance methodology used for rating certain complex financial instruments. The company agreed to pay approximately $6 million to settle the charges.

DBRS is a nationally recognized statistical rating organization that provides initial credit ratings and conducts ratings surveillance of U.S. residential mortgage backed securities, or RMBS, and re-securitized real estate mortgage investment conduits, known as re-REMICs.

The order states that DBRS misrepresented in its published 2009 U.S. RMBS Surveillance Methodology that it monitors each of its outstanding RMBS and re-REMIC credit ratings by conducting a "three-step quantitative analysis which utilizes certain assumptions concerning the performance of the collateral for those securities."

The SEC's investigation found, however, that DBRS materially misrepresented the methodology it used for its credit ratings. First, the commission alleges that DBRS "did not perform all three steps of the disclosed quantitative analysis monthly."

REUTERS/Jim Bourg

With respect to RMBS transactions, for example, the SEC alleges that "DBRS performed only the first step, reviewing monthly remittance or performance data to identify underperforming loan pools, on a monthly basis."

The order also alleges that "DBRS did not have adequate staffing and technological resources to conduct monthly the second and third surveillance steps for each outstanding rating as called for in the surveillance methodology."

The order also accuses DBRS of failing to publicly disclose material updates to its surveillance assumptions, which the agency made a few months after publishing the 2009 methodology. The company did not disclose those updates until 2011, after staff from the SEC's Office of Compliance Inspections and Examinations raised the lack of disclosure with the firm.

The charges come at a time when the SEC is increasing its focus on improving its regulations of the credit rating industry. The commission published a report in January recommending a number of changes to improve the industry, including:

- The use of affiliates or third-party contractors in the credit rating process.
- Appropriately vetting potential conflicts of interest involving a company's ratings business operations and other business segments.
- Maintaining strict adherence to an agency's own policies and procedures for determining and reviewing credit ratings.

Given the recent DBRS settlement, it is likely that the commission will continue to scrutinize how agencies adhere to their policies for determining and reviewing credit ratings. WJ

Related Court Document:
Order: 2015 WL 6447442

Bank of America asks judge to dismiss fraud suit over exchange-traded notes

By Nicole Banas, Senior Content Writer, Westlaw Daily Briefing

Bank of America Corp. wants a Vermont federal judge to throw out a securities fraud suit, saying it is based on "feigned ignorance" of the disclosures it gave to the plaintiff investors about the risks of depreciation associated with exchange-traded notes.

Flinn et al. v. Bank of America Corp., No. 15-CV-0193, memorandum in support of motion to dismiss filed (D. Vt. Oct. 19, 2015).

Gloria and Christopher Flinn's complaint is attempting to impose on Bank of America a "nonexistent obligation" to predict financial markets' performance years into the future, the bank says in a court memo supporting a motion to dismiss.

The fraud allegations are not "remotely actionable" because disclosure documents cautioned that the value of the exchange-traded notes could decrease to zero, the memo says.

ETNs are a type of debt security that promises to pay at maturity the value of the notes determined by a benchmark index, less certain fees.

From 2010 to 2011 Bank of America allegedly sold ETNs called "strategic return notes" linked to its proprietary "investable volatility index." The index measured market volatility based on the daily level of S&P 500 options.

The case is pending before U.S. District Judge Geoffrey W. Crawford of the District of Vermont.

'RIGGED' NOTES

The complaint says the Flinns in 2010 invested $200,000 in Bank of America ETNs with a five-year maturity date.

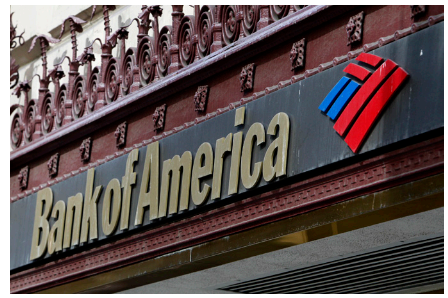
The notes' value sank over the next year, and the Flinns tried to mitigate their losses by buying resales of the notes for $50,000, according to the suit.

They ultimately lost about 95 percent of their original investment, the complaint says.

The Flinns allegedly researched the underlying mechanism of ETNs in 2013 and learned they were essentially "rigged to lose value over time."

Bank of America declined to respond to their demand for rescission, the suit says.

The Flinns allege that Bank of America favorably manipulated historical data for the volatility index and failed to disclose the mechanism for the "constant erosion" of the principal invested in the notes.



REUTERS/Fred Prouser

According to the bank, the exchange-traded notes performed "exactly as designed," decreasing in value as equity markets increased by 80 percent since 2010.

The suit seeks rescission of the Flinns' purchases and damages under the anti-fraud provision of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b).

It also includes state law claims for rescission, fraud, negligent misrepresentation, unjust enrichment and punitive damages.

INADEQUATE PLEADING

In response to the complaint, Bank of America says the plaintiffs did not adequately plead the elements of a fraud claim under the Exchange Act because they did not identify a material omission in the offering documents for the notes.

The Flinns received information about the publicly listed options from which the index is calculated, the calculation formula and the index's performance relative to the S&P 500 for the previous six years, the memo says.

According to the bank, the ETNs performed "exactly as designed," decreasing in value as equity markets increased by 80 percent since 2010.

Even though the plaintiffs' overall portfolio increased in value, they want to recoup their ETN losses based on a "feigned ignorance of comprehensive risk disclosures," the memo says.

Bank of America asserts that the complaint fails to establish other elements of a fraud claim, such as fraudulent intent and loss causation, and that it was filed outside of the applicable two-year limitations period.

The plaintiffs had "all of the facts they could possibly need" when they bought the ETNs in 2010 and 2012, the memo says.

The complaint also fails to satisfy state law pleading requirements, it says. WJ

Related Court Document:
Memo: 2015 WL 6144098

Focus to limit risk from automated bond trading, CFTC official says

(Reuters) – Any proposals to tighten oversight on automated trading in U.S. Treasuries futures would focus on measures aimed at curbing risks that stem from bad algorithms and inadequate testing of the algorithms, a top U.S. regulator said Oct. 21.

In the wake of the "flash" rally in the Treasuries futures and cash markets Oct. 15, 2014, when prices swung wildly within minutes in the absence of fundamental news, regulators have increased scrutiny on the growth of automated trading in the near $13 trillion sector.

"In the near term, we are focused on looking at operational risks, and taking steps to minimize the potential for disruptions and other operational problems that may arise," said Timothy Massad, chairman of the Commodity Futures Trading Commission in a prepared speech on Treasuries market structure at the New York Federal Reserve.

Massad said he expects the CFTC, which regulates trading of U.S. futures, to introduce some proposed reforms on automated trading in Treasuries futures in November.

Massad's remarks echoed views of other federal regulators at the event, who said they would consider more oversight on computerized trading strategies that can move billions of dollars across markets within fractions of a second.

Possible proposals on automated trading in bond futures will likely be consistent with what many firms have in place and build on what futures exchanges have done already, Massad said.

Some of these proposed measures may include pre-trade controls, such as message throttles and maximum order size limits, he said.

Other proposals would pertain to the design, testing and supervision of automated trading systems as well as measures such as "kill switches," which help with emergency intervention in the case of malfunctioning algorithms, he said.

Another area of regulatory focus, Massad said, is whether to require registration for proprietary firms that engage in algorithmic trading, not already registered with the CFTC. WJ

(Reporting by Richard Leong in New York; editing by Jeffrey Benkoe and Chizu Nomiyama)

REUTERS/Mike Segar

"In the near term, we are focused on looking at operational risks, and taking steps to minimize the potential for disruptions and other operational problems that may arise," CFTC Chairman Timothy Massad said.

MF Global customers want high court to review dismissal of claims against PwC

MF Global's customers are asking the U.S. Supreme Court to review an appeals court's decision to affirm a lower court's dismissal of fiduciary-duty and professional negligence claims against the bankrupt brokerage's auditor PricewaterhouseCoopers.

Bearing Fund LP et al. v. Pricewaterhouse Coopers LLP, No. 15-481, petition for cert. filed (U.S. Oct. 13, 2015).

The 2nd U.S. Circuit Court of Appeals had held that alleged malfeasance by now-defunct commodity futures broker MF Global precluded its customers from bringing breach-of-fiduciary-duty claims on the company's behalf because of the *in pari delicto* doctrine, which prevents wrongdoers from recovering against each other for the same malfeasance.

The panel also upheld the dismissal of the professional negligence claim against PwC because the customers had no contractual relationship with the auditor.

MF Global's trustee assigned the claims to Bearing Fund and other clients so they could sue the auditor on the company's behalf for failing to properly audit the brokerage.

> "Private actions should not be barred by the *in pari delicto* defense where application of the defense would interfere with the private enforcement of securities laws that are important to protect the public," the petition says.

MF GLOBAL'S COLLAPSE

The case stems from MF Global's alleged misuse of customer funds.

According to a Manhattan federal court's earlier ruling in the consolidated actions involving the brokerage, MF Global invested heavily in European debt securities, and when the investments turned sour, the company allegedly used $1.6 billion in customer funds to prop up the firm. *In re MF Global Holdings Inv. Litig.*, 998 F. Supp. 2d 157 (S.D.N.Y. 2014).

The brokerage filed for bankruptcy protection in October 2011.

MF Global customers and shareholders, including Bearing Fund, sued the brokerage's officers, directors and auditor in the U.S. District Court for the Southern District of New York. They alleged the company, its top executives and auditor breached their fiduciary duties by causing the firm's collapse and misappropriating customer funds.

The clients accused PwC of aiding the brokerage's fraud by failing to expose the company and its executive's malfeasance through its audits.

REUTERS/Shannon Stapleton

The cases were consolidated.

The Commodity Futures Trading Commission also sued MF Global, former CEO (and former New Jersey governor) Jon Corzine and others, alleging violations of the Commodity Exchange Act, 7 U.S.C. § 1. *CFTC v. MF Global*, No. 13-CV-04463, 2013 WL 3231494, *complaint filed* (S.D.N.Y. June 27, 2013).

On the same date, the regulator announced a settlement with MF Global. The company agreed to pay $1 billion in restitution to customers and a $100 million penalty to be paid if any assets remain after customers and other creditors are paid.

IN PARI DELICTO

The defendants moved to dismiss the consolidated customer and shareholder suit, arguing they breached no duty to shareholders, no duty existed between themselves and MF Global's customers, and PwC was not liable for customer losses.

U.S. District Judge Victor Marrero granted the motion in part early last year. *In re MF Global Holdings Invest. Litig.*, 998 F. Supp. 2d 157 (S.D.N.Y. 2014).

MF Global's investors and customers cannot pursue fiduciary-duty claims against the executives but can pursue claims of aiding and abetting, negligence, conversion, and tortious interference, he ruled.

But the *in pari delicto* doctrine barred the investors and customers from pursuing claims against the auditor, the judge said.

The 2nd Circuit upheld the judge's ruling on the customers' appeal, saying MF Global customers cannot bring fiduciary-duty claims against the auditor on MF Global's behalf.

"The allegation defeats the claim: A corporation that engages in malfeasance cannot sue outside accountants who negligently failed to detect or prevent that malfeasance," the appellate panel said.

The clients are now appealing that decision to the Supreme Court.

The "2nd Circuit's holding cannot be correct where, as here, permitting the *in pari delicto* defense eviscerates a federal statutory and regulatory scheme designed to protect commodity investors," the petition says.

The Supreme Court limited when the doctrine can bar a private action in *Bateman Eichler, Hill Richards Inc. v. Berner,* 472 U.S. 299 (1985), and *Pinter v. Dahl,* 486 U.S. 622 (1988).

"[P]rivate actions should not be barred by the *in pari delicto* defense where application of the defense would interfere with the private enforcement of securities laws that are important to protect the public," the clients argue. WJ

Related Court Document:
Petition: 2015 WL 6083237

JPMorgan 'excessive' fees topped $132 million a year, suit says

By Peter H. Hamner, Esq., Senior Legal Writer, Westlaw Journals

JPMorgan and its affiliates breached their fiduciary duties to several mutual funds by setting their investment advisory and administrative fees $132.1 million per year above standard rates, a recently filed lawsuit says.

Campbell Family Trust et al. v. JP Morgan Investment Management Inc. et al., No. 2:15-cv-02923, complaint filed (S.D. Ohio Oct. 16, 2015).

The suit filed in the U.S. District Court for the Southern District of Ohio claims the fees set by JPMorgan Investment Management Inc., JP Morgan Funds Management Inc. and JPMorgan Chase Bank violate Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b).

Campbell Family Trust, Jack Hornstein, Anne H. Bradley, Casey Leblanc, Jacqueline Peiffer, Joseph Lipovich and the Valderrama Family Trust filed the complaint on behalf of JPMorgan Mid Cap Value Fund, JPMorgan Large Cap Growth Fund, JPMorgan Value Advantage Fund, JPMorgan Strategic Income Opportunities Fund and JPMorgan US Equity Fund — all statutory trusts organized under Delaware law and registered as mutual funds under the Investment Company Act.

Mutual funds are collective investments that pool money from investors to invest in a group of securities. For instance, the Mid Cap Value Fund invests in equity securities of companies whose market capitalization is between $1 billion and $20 billion.

JPMorgan Investment Management is the investment adviser to the Mid Cap Value Fund, the Large Cap Growth Fund and the Value Advantage Fund, while JPMorgan Funds Management and JPMorgan Chase Bank are the administrators for those three funds and the Strategic Income Opportunities Fund and the US Equity Fund.

According the suit, the assets under management for the funds has increased dramatically from 2008 to 2015. As a result, JPMorgan Investment Management collects as much as $84.5 million more in fees per year compared to the fees it would receive were its services negotiated at arm's length, the suit says. The total amount has increased 411 percent over the past few years, the suit says.

> The fees "are so disproportionately large that they bear no reasonable relationship to the value of the services provided," the suit says.

JPMorgan Funds Management Inc. and JPMorgan Chase Bank receive as much as $47.6 million more in fees per year than they would had the fee rates been negotiated at arm's length, the suit says.

The JPMorgan affiliates have realized the benefits of increased assets under management but have not changed their fee structure to accommodate the changes, contrary to industry practice, the suit says.

Additionally, the administrative fees are duplicative and higher than those charged to unaffiliated clients, the plaintiffs claim.

Ordinarily, the fee rate structure includes breakpoints that reduce the fee rate paid by a fund based on the benefits of economies of scale, the complaint says. The fees are paid from the fund's assets and directly reduce the fund's value.

"The payment of excessive investment advisory and administration fees to defendants harms each of the funds on a going-forward basis because each fund loses investment returns and profits it could earn on the amounts paid as excessive fees if those amounts were available for investment," the complaint says.

The fees are "so disproportionately large that they bear no reasonable relationship to the value of the services provided," the suit says.

The plaintiffs allege the fees breach fiduciary duties owed to the funds under Section 36(b) of the Investment Company Act.

They are seeking unspecified actual damages, rescission and restitution of the allegedly excessive fees, rescission of the investment advisory and administration agreements, and reasonable litigation costs.

A JPMorgan spokesperson declined to comment on the suit. WJ

Related Court Document:
Complaint: 2015 WL 6166598

7th Circuit asked to rehear case on constitutionality of SEC judge appointments

A former CEO of Assisted Living Concepts Inc. has asked the full 7th U.S. Circuit Court of Appeals to review an earlier decision that allowed the Securities and Exchange Commission to continue its administrative proceeding against her.

***Bebo v. Securities and Exchange Commission*, No. 15-1511, *petition for reh'g en banc filed* (7th Cir. Oct. 8, 2015).**

In her petition for a rehearing *en banc*, former Assisted Living CEO Laurie A. Bebo says a three-judge panel of the court incorrectly affirmed a lower court's ruling that it lacked jurisdiction to enjoin the SEC's enforcement proceeding.

SEC ALLEGATIONS

The case stems from administrative charges the agency brought against Bebo in December 2014.

Assisted Living is a Wisconsin-based, publicly traded assisted living and senior residence company.

Bebo violated federal securities laws by engaging in a fraudulent scheme that listed fake occupants at some of the company's senior citizen residences to avoid defaulting on the facilities' leases, the agency claimed.

The company and Bebo knowingly misrepresented in its periodic SEC filings that it complied with its lease agreements, the regulator said.

The SEC said the public statements about the leases were false and misleading and violated the anti-fraud provision outlined in Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).

Bebo sought to enjoin the administrative proceeding by suing the agency in the U.S. District Court for the Eastern District of Wisconsin, contending its process for appointing administrative judges violates the Constitution.

Bebo argues the appointment of administrative law judges without confirmation by agency commissioners violates Article II of the U.S. Constitution.

Article II gives the president the power to appoint executive branch officers, but Congress can vest the appointment of "inferior" officers to the head of the officer's department, the suit says.

SEC judges are inferior officers and must be appointed by SEC commissioners, Bebo says.

U.S. District Judge Rudolph T. Randa dismissed Bebo's suit in March, saying she was required to challenge the proceedings' constitutionality first before the agency and then before a federal appeals court. *Bebo v. SEC*, No. 15–C–3, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015).

> "[The] appeal involves a question of exceptional importance to the law of federal court jurisdiction and constitutional separation of powers," the petition says.

The 7th Circuit affirmed Judge Randa's dismissal in August. *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

District courts lack the authority to review SEC administrative proceedings because that power lies with the courts of appeal, the lower court and appeals panel ruled.

SEC administrative law judge Cameron Elliot ruled in favor of the agency Oct. 2, ordering Bebo to pay a $4.2 million civil penalty. *In re Bebo et al.*, No. 3-16293, 2015 WL 5769700 (S.E.C. Oct. 2, 2015).

Bebo is now asking the full 7th Circuit to rehear the case, saying the "appeal involves a question of exceptional importance to the law of federal court jurisdiction and constitutional separation of powers."

OTHER SEC CHALLENGES

Several other plaintiffs have challenged the SEC's process of appointing ALJs.

The 2nd Circuit recently heard oral argument on this issue in *Tilton v. SEC*, No. 15-2103, *oral argument heard* (2d Cir. Sept. 16, 2015).

The SEC charged Patriarch Partners and CEO/founder Lynn Tilton with misrepresenting the risks of assets underlying three collateralized loan obligation funds worth over $2.5 billion.

In another case, U.S. District Judge Richard M. Berman of the Southern District of New York ruled the SEC cannot proceed with an enforcement action against Standard & Poor's Rating Services co-manager Barbara Duka. *Duka v. SEC*, No. 15-cv-357, 2015 WL 4940083 (S.D.N.Y. Aug. 12, 2015).

The agency is appealing that decision. *Duka v. SEC*, No. 15-2732, *notice of appeal filed* (2d Cir. Aug. 27, 2015).

The SEC is also appealing a decision by U.S. District Judge Leigh Martin May of the Northern District of Georgia to halt the SEC's action against Gray Financial. *Gray Fin. Grp. et al. v. SEC*, No. 15-13738, *reply brief filed* (11th Cir. Oct. 13, 2015).

The agency alleges the company and its executives advised their public pension fund clients to buy investments that failed to comply with Georgia's statutory investing restrictions for public pensions. WJ

Related Court Document:
Petition: 2015 WL 6125480

SEC proposes liquidity risk management rules for open-end funds

By W. John McGuire, Esq., John J. O'Brien, Esq., Laura E. Flores, Esq., Christopher D. Menconi, Esq., and K. Michael Carlton, Esq., *Morgan Lewis & Bockius*

In the second step of its five-part plan to enhance registered funds regulations, the SEC has proposed new requirements on portfolio liquidity, risk monitoring, and board oversight.

At an open meeting held on September 22, the Securities and Exchange Commission (SEC) unanimously approved a proposal that is designed to strengthen the management of liquidity risk by certain registered open-end investment companies, including mutual funds and ETFs.[1]

The SEC's proposal creates new Rule 22e-4 under the Investment Company Act of 1940 (1940 Act), which would require funds to establish a liquidity risk management program and determine a minimum percentage of net assets that must be convertible to cash within three days.

The SEC's proposal would also enhance liquidity disclosure requirements, codify SEC guidance that limits a fund's illiquid investments to 15% of the fund's net assets, and amend Rule 22c-1 under the 1940 Act to permit certain funds to use "swing pricing," which would allow managers to adjust the price at which shareholders transact in fund shares during periods of heavy redemptions or purchases.

The proposal seeks to enhance a fund's ability to meet redemption requests while mitigating dilution of shareholders, particularly during periods of market disruption.

SEC Chair Mary Jo White noted that the proposed rule is the next step in the SEC's five-part plan to enhance the regulation of risks that arise from portfolio composition and the operations of funds and investment advisers.

This plan includes measures to (1) enhance data reporting (as proposed this past May),[2] (2) strengthen the management of fund liquidity, (3) better address risks from funds' use of derivatives (a proposal is anticipated by the end of this year), (4) plan for the transition of client assets, and (5) "stress test" funds and advisers.

Chair White explained the necessity for improved liquidity risk management rules by emphasizing the rise of fund strategies that rely on securities that tend to be less liquid, such as high-yield bonds, emerging market securities, and alternatives.

The proposal seeks to enhance a fund's ability to meet redemption requests while mitigating dilution of shareholders, particularly during periods of market disruption.

She stated that SEC staff economists have found that foreign bond funds and alternative strategy funds have historically experienced more unpredictable purchases and redemptions than average mutual funds.

The SEC's package of proposals would require open-end funds — including mutual funds and ETFs, but not money market funds — to take the following actions:

Establish a liquidity risk management program.

Under the program, a fund would classify the liquidity of each of its holdings based on the number of days that it would take to convert a position to cash without a market impact.

Assets are assigned to one of six categories (or "buckets") based on the amount of time they would take to be liquidated.

Proposed rule 22e-4 provides a number of factors to be considered by fund boards as they assess and monitor the liquidity risk of fund assets, including, among others, whether the asset is listed on an exchange; the number, diversity and quality of market participants; trading frequency and volume; price volatility; bid-ask spreads; and position size.

In classifying the liquidity of an asset, a fund also would be required to consider the asset's relationship to another portfolio asset, such as when a fund "covers" a derivatives position by maintaining otherwise liquid assets in a segregated account.

Under the proposal, the liquidity of such segregated assets would be classified by reference to the liquidity of the derivatives position they are covering because the segregated assets would not be available to meet redemptions until the derivatives position is unwound or the segregated assets are replaced with different assets.

Each program would have to be tailored to a fund's specific portfolio and risks, and fund boards would be required to annually review and approve the program.

Third-party services that assist funds in making liquidity determinations, including some new services that are coming to market, could be used in meeting this requirement.

Cap illiquid assets at 15%.

The proposed rule would formalize current SEC guidance that limits a fund's ability to invest in illiquid assets to 15% of the fund's net assets.

This limitation also would be required to be monitored as part of the fund's liquidity risk management program.

Because the liquidity risk management program would require a fund to categorize its assets according to the amount of time it would take to liquidate them based on market, trading, and asset-specific factors, a fund would not need to consider the size of the fund's position in an asset or the number of days needed to convert the asset to cash in determining whether the asset is subject to the 15% limit.

Determine minimum percentage of net assets convertible to cash in three days.

As part of the liquidity risk management program, a fund would be required to determine a minimum percentage of its net assets that must be invested in cash and assets that are convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to the sale.

This three-day liquid asset minimum would be established by a fund based on its investment strategy, cash flow projections, use of borrowings and derivatives for investment purposes, and other factors.

The minimum percentage must be approved by the fund's board of directors and is subject to review by the board.

Enhance disclosure and reporting.

The proposal would amend Form N-1A to require funds to disclose their liquidity risk management practices, including, if applicable, the use of swing pricing.

Funds would also be required to file any agreements for bank lines of credit as exhibits to their registration statements.

Funds would need to disclose the liquidity classification of fund assets and the three-day liquid asset minimum in Form N-PORT.[3]

Funds would also be required to disclose information regarding committed lines of credit, interfund lending and "swing pricing" in Form N-CEN.

> The proposed rule would formalize current SEC guidance that limits a fund's ability to invest in illiquid assets to 15% of the fund's net assets.

These reporting requirements build on the reporting regime set forth in the Investment Company Reporting Modernization Release proposed on May 21, 2015.

Use "swing pricing."

Proposed amendments to Rule 22c-1 under the 1940 Act would permit, but not require, open-end funds other than money market funds and ETFs to use swing pricing.

Swing pricing would allow a fund to adjust the value at which investors purchase or redeem their shares when shareholder redemptions or purchases surpass certain thresholds that have been pre-approved by the fund's board.

Funds may elect to establish swing thresholds that would be triggered when levels of net purchases into or redemptions out of a fund exceed a specified percentage of the fund's NAV.

The amended rule would set forth factors to be considered by the board in determining swing thresholds and require that swing thresholds be reviewed annually.

If a swing threshold is triggered, the fund would apply a swing factor to the fund's NAV.

This would allow funds to adjust downward the price at which investors cash out of a fund if they sell shares during periods of high redemptions (or adjust upward during periods of net purchases).

Swing pricing attempts to ease the burden on existing shareholders by distributing to purchasing and redeeming shareholders the trading costs associated with high purchases and redemptions.

Swing policies and procedure would be reviewed and approved annually by the board and the independent directors.

ETFs are not included within the scope of the swing pricing proposal because the SEC believes that ETFs' purchase and redemption practices do not generally entail the risk of dilution as a result of authorized participants' purchase and redemption activity, and that swing pricing could impede the effective functioning of an ETF's arbitrage mechanism.

Although the proposal received unanimous approval, Commissioners Gallagher and Piwowar expressed concerns regarding the imposition of a three-day asset minimum and the use of swing pricing.

Both Commissioners advocated that a seven-day asset minimum would be more appropriate given its statutory basis in Section 22(e) of the 1940 Act and the fact that many funds are not required to deliver assets to redeeming shareholders in three days or less.

With respect to swing pricing, Commissioner Gallagher suggested that funds should have the flexibility to approve different swing thresholds for large redemptions and large purchases or only apply swing thresholds to large redemptions.

Commissioner Piwowar expressed his concern that swing pricing would cause investors to employ "gaming behavior" as investors try to predict how large redemptions will affect NAV.

He also sought out comments on alternative methods for mitigating shareholder dilution from large redemptions and questioned if liquidity or redemption fees, like those proposed as part of the new money market fund reform rules, would offer a better solution.

> Under the program, a fund would classify the liquidity of each of its holdings based on the number of days that it would take to convert a position to cash without a market impact.

In addition, he asked that academic economists weigh in on how swing pricing affects the use of market investment tools like alpha, beta, sharp ratios and tracking error.

Commissioner Stein, on the other hand, asked commenters to consider whether the proposed rules go far enough and whether the rules should be tailored specifically to those funds that raise the greatest liquidity concerns. She asked if such funds would be better classified as closed-end funds or private funds.

If adopted as proposed, new Rule 22e-4 and the amendments to Rule 22c-1 would impose even more burden on funds' compliance personnel, portfolio managers, and operations personnel. Similar to the money market fund enhancements that were adopted in 2014, the proposals would also add to the responsibility of the board of directors and require new assessments and determinations.

Once the proposed rule is published in the Federal Register, commenters will have ninety days to provide comments, which is thirty days more than the usual 60-day comment period WJ

NOTES

[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release No. 33-9922 (Sept. 22, 2015), *available at* https://www.sec.gov/rules/proposed/2015/33-9922.pdf.

[2] *See* our May 2015 LawFlash "SEC Proposes Rules Affecting Funds and Advisers" *available at* http://www.morganlewis.com/pubs/sec-proposes-rules-affecting-funds-and-advisers.

[3] This requirement extends from the SEC's initial proposal to establish Form N-PORT, which would have required all funds to report whether fund investments are illiquid assets in Item C.7 of Form N-PORT. *See* Investment Company Reporting Modernization, SEC Release No. 33-9776 (May 21, 2015), *available at* http://www.sec.gov/rules/proposed/2015/33-9776.pdf.





(From L-R) **John McGuire** counsels clients in **Morgan Lewis & Bockius**' Washington office on investment company and investment adviser regulatory issues and related issues affecting broker-dealers and transfer agents. He also assists clients with forming and acquiring investment companies and investment advisers. He routinely handles matters involving the establishment, representation, and counseling of exchange traded investment companies, their advisers, and listing markets. **John J. "Jack" O'Brien** counsels registered and private funds and fund managers in connection with organizational, offering, transactional, and compliance matters in the firm's Philadelphia office. He regularly works with a variety of different fund structures, including open-end and closed-end funds, exchange-traded funds, and hedge funds. **Laura E. Flores**' practice focuses on the regulation of investment companies and investment advisers in the firm's Washington office. She regularly represents exchange-traded funds, mutual funds, and variable insurance-dedicated products, as well as their sponsors and boards of directors, and investment advisers. **Christopher Menconi** advises investment companies, including mutual funds and exchange-traded funds and their investment advisers and boards of directors on regulatory, compliance, organizational and operational matters in the firm's Washington office. He also advises insurance companies on the regulation of variable insurance products under the federal securities laws. **Michael Carlton** focuses his practice on the regulation of investment companies and investment advisers in the firm's Washington office. This commentary was originally published as a LawFlash alert Sept. 28 on the Morgan Lewis website. Reprinted with permission.

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