Investment Management Regulatory Update

December 21, 2017

Rules and Regulations

- CFTC Proposes to Clarify the Treatment of Leveraged, Margined, or Financed Retail Virtual Currency Transactions

Industry Update

- SEC Announces Updates to Form N-PORT Filing Requirements

Litigation

- SEC Charges Investment Adviser and Principals for Undisclosed Conflicted Transactions
- SEC Charges Adviser with Misrepresentations in Offering Documents and Misappropriation of Investor Funds
- Large Broker-Dealer Settles with FINRA for Delivery System Failures Relating to ETF Prospectuses

Rules and Regulations

CFTC Proposes to Clarify the Treatment of Leveraged, Margined, or Financed Retail Virtual Currency Transactions

Among the virtual currency transactions that are within the scope of CFTC regulation are leveraged, margined, or financed transactions in virtual currencies offered to retail customers. These retail commodity transactions are illegal unless traded on a regulated futures exchange and cleared through a futures commission merchant. They include any transaction: in a commodity (including virtual currencies but not foreign currency or securities); with a customer that is not an eligible contract participant; and that is offered on a leveraged, margined, or financed basis.

The CEA exempts from this treatment any transaction that "results in ***actual delivery*** [of the underlying commodity] within 28 days" (emphasis added). On December 15, 2017, the **CFTC proposed an interpretation** of "actual delivery" for purposes of this exemption in the context of virtual currency transactions. Comments on the proposal are due 90 days after its publication in the Federal Register.

A Brief Background

Although not specifically referenced in the CFTC's release, the proposal may be, at least in part, a response to a **petition for rulemaking** submitted to the CFTC in 2016. That petition was spurred by a position taken by the CFTC in its **enforcement order against Bitfinex**, a virtual currency exchange, which involved the offering of illegal off-exchange retail commodity transactions in bitcoin. In that enforcement order, the CFTC asserted that actual delivery of bitcoin will not have occurred where delivery of bitcoin is evidenced by accounting entries in an exchange's own database, whether the delivered bitcoin is held for individual customers in an omnibus digital currency wallet or in individual customer digital wallets, if the exchange retains control over the private keys for those wallets. The petition argues against the CFTC conditioning actual delivery of a virtual currency on the recipient having control over the private key to the digital currency wallet to which the virtual currency was delivered.

The Proposal

In its proposal, the CFTC sets out two key conditions for a virtual currency transaction to satisfy the actual delivery requirement under the exemption. These conditions, quoted in full, are:

1. A customer having the ability to: (i) take possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement, and (ii) use it freely in commerce (both within and away from any particular platform) no later than 28 days from the date of the transaction; and
2. The offeror and counterparty seller (including their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) not retaining any interest in or control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction.

The CFTC would consider the offeror of a virtual currency transaction to include "a virtual currency platform that makes the transaction available to the retail customer or otherwise facilitates the transaction."

The proposal includes two examples of transactions that the CFTC would view as actual delivery and two examples that would not satisfy that requirement. It also sets out nine questions (with subparts) on which the CFTC is specifically seeking feedback.

Initial Observations

The proposal represents an important step by the CFTC to clarify the treatment of many types of retail virtual currency transactions and should be of great interest to virtual currency exchanges and retail participants of those exchanges.

- *Continuation of Bitfinex*. The proposal represents the same general view expressed by the CFTC in the Bitfinex enforcement order. As made clear by the examples provided in the release, the CFTC would not view actual delivery of a virtual currency to have occurred unless a virtual currency transaction is both reflected on the blockchain for that virtual currency (not only on a separate ledger maintained by a virtual currency exchange) and where the full amount of the currency is delivered to a virtual currency wallet under the full control of the intended recipient and with no control asserted by the offeror or seller.
- *The role of agents recognized*. The proposal specifically recognizes the possible role of an agent in holding virtual currency for a purchaser. The agent, according to example 2 in the release, would need to have an agreement with the purchaser to hold virtual currency for the purchaser without regard to any asserted interest of the offeror or seller in that virtual currency and who is not the offeror or seller. The release asks whether the agent should be subject to specific regulatory or licensing requirements.
- *Multi-sig solutions?* The proposal states that, for a virtual currency transaction to have resulted in actual delivery, the offeror or seller of the virtual currency may not retain any interest or control over any of the virtual currency purchased. This position raises questions about whether multi-sig solutions can be modified or developed to ensure actual delivery for purposes of CFTC regulations.
- *Fostering innovation*. A theme of the release is the CFTC's desire to not stifle innovation in the virtual currency markets, in recognition that "certain virtual currencies and their underlying blockchain technologies have the potential to yield notable advancements in applications of financial technology." The CFTC asks for comment on the factors that may be relevant in exercising its authority under the CEA to exempt retail commodity transactions in virtual currencies from the requirement that they be treated as futures contracts.

As the CFTC considers a final interpretation of actual delivery for virtual currencies, those who operate virtual currency businesses or transact in these markets should consider providing thoughtful and constructive input on the proposal. Given the rapid development of these markets and technologies underlying virtual currencies, the market should assist the CFTC in establishing interpretation that is sufficiently flexible to appropriately accommodate new activities and technologies as they emerge.

Industry Update

SEC Announces Updates to Form N-PORT Filing Requirements

On December 8, 2017, the SEC issued a temporary final rule (the "**Temporary Rule**") providing for, among other things, a nine-month delay to the dates by which certain registered investment companies are required to file new Form N-PORT on the EDGAR system. For a discussion of the series of rules, forms and amendments under which Form N-PORT was adopted (the "**Modernization Rules**"), see the **October 31, 2016 Davis Polk Client Memorandum, SEC Adopts Rules to Modernize Information Reported by Investment Companies**.

The Temporary Rule contains the following key changes to Form N-PORT compliance dates and related requirements:

- *Form N-PORT*. The Modernization Rules originally provided for a compliance date of June 1, 2018 for larger fund groups (*i.e.*, those with net assets of $1 billion or more) and June 1, 2019 for smaller fund groups (*i.e.*, those with net assets below $1 billion). The Temporary Rule does not change the compliance date for larger fund groups but delays the compliance date for smaller fund groups to March 1, 2020. However, for the first nine months after the June 1, 2018 compliance date for larger fund groups (*i.e.*, until March 1, 2019), larger fund groups will not be required to *file* Form N-PORT on EDGAR but will instead be required to gather and maintain the information required by Form N-PORT in their records and make such information available to the SEC upon request. On the other hand, smaller fund groups will not be subject to the requirement to gather and maintain information in advance of their compliance date. Under the Temporary Rule, all registered investment companies will continue to file existing Form N-Q until they begin filing Form N-PORT. Since Form N-PORT requires the reporting of portfolio-wide and position-level information on a monthly basis no later than 30 days after each month-end, the first filing date for larger fund groups is April 30, 2019 (relating to March 31, 2019 month-end data) and the first filing date for smaller complexes is April 30, 2020 (relating to March 31, 2020 month-end data).
- *Liquidity Data*. While the reporting of liquidity data on Form N-PORT (including each portfolio investment's liquidity classification and the aggregate percentages of portfolio investments in each of four liquidity categories) is delayed in accordance with the delay in Form N-PORT filing requirements described above, under the Temporary Rule, registered investment companies will be required to gather and retain the information required by Rule 22e-4 under the Investment Company Act of 1940, as amended (the "**Investment Company Act**") in their records and make such information available to the SEC upon request by January 30, 2019 (for larger fund groups) and July 30, 2019 (for smaller fund groups).
- *Form N-CSR*. The Temporary Rule also delays the compliance dates for amendments to Form N-CSR's certification requirements by nine months—*i.e.*, March 1, 2019 for larger fund groups and March 1, 2020 for smaller fund groups.
- *Form N-CEN*. The Temporary Rule does not modify the requirements of new Form N-CEN or its compliance date, which is June 1, 2018 for all fund groups.

► **See a copy of the Temporary Rule**

Litigation

SEC Charges Investment Adviser and Principals for Undisclosed Conflicted Transactions

On October 26, 2017, the SEC issued an order (the "**Order**") instituting and settling administrative and cease-and-desist proceedings against Augustine Capital Management, LLC ("**Augustine**") and two principals (each, an "**Augustine Principal**" and together with Augustine, the "**Augustine Parties**"), for failing to disclose and seek consent in instances of conflicted transactions, improperly charging certain fees and expenses to a managed fund and providing investors with misleading account statements.

According to the Order, in late 2011 and early 2012, the Augustine Principals caused Augustine Fund, L.P. (the "**Fund**"), for which Augustine served as investment adviser, to make investments totaling $500,000 in a newly formed portfolio company ("**Company 1**"). The Augustine Principals allegedly held significant ownership interests in Company 1 at the time of investment, and no advisory committee or other independent entity had consented to the conflicted transaction. Subsequently, the Order alleged, the Augustine Principals re-purchased the Fund's interest in Company 1 for $400,000 in December 2013. According to the Order, at no point in time was the Fund's investment in Company 1, the Augustine Principals' ownership stakes in Company 1 or the 20% loss on the investment disclosed to Fund investors. The Order further alleged that from 2012 to 2014, the Fund made a series of loans to a wholly owned subsidiary of Company 1 for the purpose of covering margin calls unrelated to the Fund, and also made a $250,000 loan to one of the Augustine Principals to pay for his ownership interest in Company 1. These transactions were not, according to the Order, disclosed to Fund investors—indeed, the Order alleged that when certain Fund investors requested a description of the investments they held, the Augustine Principals engaged in email exchanges discussing ways to conceal the loan transactions involving Company 1. More generally, according to the Order, the Augustine Parties regularly provided investors with misleading account statements that failed to accurately reflect the values of underlying investments, many of which were bankrupt or worthless. Lastly, the Order alleged that Augustine charged the Fund for all of its expenses—including overhead and employee salaries—despite provisions in the Fund's governing documents that permitted only certain operating expenses to be charged to the Fund. According to the Order, these improper expense allocations resulted in the Fund being overcharged by nearly $950,000.

According to the Order, as a result of the conduct described above, the Augustine Parties willfully violated (i) Sections 206(1) and 206(2) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), which generally prohibit investment advisers from engaging in fraudulent behavior with respect to any client or prospective client; and (ii) Section 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder, which generally prohibit investment advisers from making any untrue statement of material fact or omitting a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading to any investor or prospective investor.

The Augustine Parties consented to the entry of the Order without admitting or denying the findings and agreed to pay $685,514.73 in disgorgement, $42,791.38 in prejudgment interest and $275,000 in civil monetary penalties.

- **See a copy of the Order**

SEC Charges Adviser with Misrepresentations in Offering Documents and Misappropriation of Investor Funds

On December 5, 2017, the SEC filed a complaint (the "**Complaint**") in the Southern District of Texas charging defendants James C. Tao (the "**Adviser**") and Donna Boyd (together with the Adviser, the "**Defendants**") with violations of the anti-fraud provisions of the federal securities laws and for acting as unregistered brokers in violation of Section 15(a) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") in connection with the offering and sale of interests in a private equity fund (the "**PVC Fund**") formed by Defendants.

According to the Complaint, while operating a branch office of a registered investment adviser and broker-dealer in Houston, Texas (the "**Registered Firm**"), Defendants formed the PVC Fund in 2012 to purportedly invest in Houston-area technology start-up companies. The SEC alleged that, while the Registered Firm had a process in place for vetting and approving alternative investments, Defendants chose not to submit the PVC Fund to the Registered Firm for consideration and, without the Registered Firm's knowledge or approval, raised approximately $860,000 by selling interests in the PVC Fund to their advisory clients and brokerage customers at the Registered Firm and to other family, friends and contacts in a practice known as "selling away."

According to the Complaint, the offering documents pursuant to which interests in the PVC Fund were offered stated that until $2.5 million was raised, proceeds would be held in escrow with the PVC Fund's bank and that the PVC Fund would refund all of the subscription funds received if a minimum amount of interests had not been sold by the expiration date of the offering. The SEC alleged, however, that these representations were false because the Adviser did not establish any escrow account, but instead began deploying investor funds soon after they were received.

In addition, according to the Complaint, the Adviser caused the PVC Fund to invest more than $200,000 in his own companies or companies in which he had a personal interest, some of which did not fit the stated business model of investments in local technology start-ups, and failed to adequately disclose his conflicts of interest in breach of his fiduciary duties to his advisory clients. The Complaint also noted that the Adviser touted a 12% historical rate of return, which was derived from an average rate of return for all private equity funds over the past two decades and bore no connection to the historical experience of the PVC Fund or its managers.

Further, the SEC alleged that the Adviser misappropriated investor funds for purposes not authorized under the PVC Fund's offering documents, including to pay a loan origination fee to the relative of a Fund employee (without the PVC Fund receiving such loan) and to buy out certain of the PVC Fund's investors prior to the two-year lock-up period provided by the PVC Fund's offering documents.

The SEC alleged that as a result of the conduct described above, the Adviser violated the anti-fraud provisions of Section 17(a) of the Securities Act of 1933, as amended, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-8 thereunder. In addition, the SEC alleged that, in connection with the offering of interests in the PVC Fund, Defendants acted as brokers within the meaning of Section 3(a)(4) of the Exchange Act without registering with the SEC and their association with the Registered Firm did not exempt Defendants from registration as the transactions at issue were not made within the scope or course of Defendants' employment with the Registered Firm.

The Complaint seeks an injunction permanently enjoining the applicable Defendant(s) and their agents from such securities laws violations and from soliciting or accepting funds for any unregistered offering of securities, a disgorgement of all ill-gotten gains and/or unjust enrichment realized by the Adviser (plus prejudgment interest) and payment appropriate civil monetary penalties by Defendants.

- **See a copy of the Complaint**

Large Broker-Dealer Settles with FINRA for Delivery System Failures Relating to ETF Prospectuses

On December 1, 2017, the Financial Industry Regulatory Authority's ("**FINRA**") Department of Enforcement issued a Letter of Acceptance, Waiver and Consent (the "**Letter**") settling charges against a large broker-dealer and FINRA member ("**Firm**") for failing to establish, maintain and enforce a supervisory system and supervisory procedures in connection with the delivery of prospectuses for exchanged-traded funds ("**ETFs**") required to be provided under Section 5(b)(2) of the Securities Act.

According to the Letter, between 2008 and 2014, the Firm cleared over 100 million ETF purchases for its clients and developed a system for delivering prospectuses in connection with their customers' initial purchases of ETFs. According to the Letter, there were three failures with the delivery system: (1) after the Firm stopped using tax identification numbers in order to protect client information, the Firm failed to replace such numbers with another unique client identifier, resulting in the delivery system failing to recognize that prospectuses needed to be sent; (2) when an operational error led the Firm to send mailing labels to an incorrect printing queue, the delivery system failed to generate alerts to the Firm that the print instructions had not been delivered to the third-party vendor contracted to mail prospectuses, resulting in the vendor not receiving the labels and the prospectuses not being sent to customers; and (3) the Firm's delivery system did not account for changes or updates to prospectuses that would require such updated prospectuses to be delivered to the Firm's customers. In addition, according to the Letter, the Firm did not have sufficient procedures in place for testing its delivery system because although the Firm regularly requested confirmation from the third-party vendor that a selected sample of prospectuses had been sent, the third-party vendor viewed such requests as instructions only to send those specific prospectuses. Moreover, while the Firm kept a daily production log of the prospectuses to be delivered and the mailing labels for each, the Firm failed to compare this log with the third-party vendor's data on the prospectuses actually mailed.

As a result of the failures described above, FINRA found that the Firm violated, among others, (i) NASD Rule 3010(a) and (b), which require FINRA members to establish, maintain and enforce systems and procedures to supervise its employees that are reasonably designed to comply with securities laws and regulations and (ii) NASD Rule 3012, which requires FINRA members to establish a system of supervisory control policies and procedures designed to test and verify that such member's representatives and associates comply with applicable securities laws and regulations.

The Firm agreed to be censured and consented to the Letter without admitting or denying FINRA's findings. FINRA ordered the Firm to pay a fine of $700,000 and to undertake, within 90 days of the Letter, to submit a certification to FINRA that the Firm's policies, systems and procedures (including written procedures) and training are reasonably designed to achieve compliance with Section 5(b)(2) of the Securities Act and any applicable regulatory exchange rules in connection with the delivery of ETF prospectuses.

- **See a copy of the Letter**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
Yukako Kawata	**212 450 4896**	**yukako.kawata@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Jai Massari	**202 962 7062**	**jai.massari@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Sijia Cai	**212 450 3071**	**sijia.cai@davispolk.com**
Trevor I. Kiviat	**212 450 3448**	**trevor.kiviat@davispolk.com**